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16th July 2015

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

Dear Eliza,

We are grateful for the opportunity to provide our input to Ofgem's consultation on operators' pension deficits.

We set out our response in two sections. The first is a general commentary on the issue of funding the established deficit and the second section responds to Ofgem's specific questions in the consultation document.

General response

Throughout this response we comment in relation to the established deficit only. For the Gas Distribution Networks (GDNs) this is the deficit in respect of service accrued up to and including 31 March 2013. In accordance with the Pension and RIIO principles, any deficit arising in respect of service earned after the cut off date for the established deficit is funded as part of Totex by the Network Operators (NWOs).

Pensions form an important part of the employment package available to employees. It is up to each NWO to construct an employment package that they consider is adequate to attract and retain staff of appropriate knowledge and skill in order for it to operate efficiently.

We have taken actions since our formation as Wales & West Utilities Ltd (WWU) in 2005 to mitigate the impact of Defined Benefit pension costs by:-

- Recruiting all new staff with access to the defined contribution section of the pension scheme only,
- Modernising the standard terms and conditions of staff employed since 2005,
- Updating standard working times to better reflect the workload patterns to which we react for all industrial staff, whether members of the DB or DC section of the pension scheme,
- Transferred a significant proportion of the manager population onto personal contracts, removing their overtime entitlement and making bonuses non-pensionable, and
- undertaking a number of voluntary early retirement and severance exercises to prevent future accrual.

The main area of clarity that the current consultation addresses is the recovery period for the established deficit. We previously understood that the established deficit was to be funded over a fifteen year period from the date of establishment of that deficit. Where there were changes in the size of that deficit arising on subsequent triennial valuations, such true ups would be recovered over the remaining period of that original fifteen year timeframe.

However, in the case where there was a significant deficit recognised through a valuation towards the end of that fifteen year recovery period, recovering significant sums over a very limited number of years could place undue burden on consumers at that time.

We understand that Ofgem is looking to clarify this position in the current consultation. The proposal is; where there is an increase in the established deficit at subsequent triennial valuations, then there is the flexibility to recover the increase over an extended period, commencing on the effective date of the valuation which resulted in that increase. Thus ensuring that current consumers are not unfairly burdened with the increased cost to the benefit of future consumers.

As a general principle we agree with this approach.

For the proposed approach to operate appropriately, it is important that support is received from The Pension Regulator (tPR) to the proposed approach for funding the established deficit. Without this support it would be more difficult for Trustees to accept a lengthening of the period over which the deficit is removed.

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Specific responses to Ofgem's questions

1. Reasons for change

Q1. Do you believe our proposals will provide protection against adverse cost of capital issues?

- Increased clarity on Ofgem's approach to funding the established deficit is beneficial, especially where the approach has the support of tPR. It should though be noted that there is a higher risk that the scheme will be fully funded at a later date than current principles would achieve (a fixed fifteen year end date vs a rolling recovery period for any increase in the established deficit).
- We are pleased to note Ofgem continues its commitment to full funding of the established deficit.

2. Funding period

Q1. What do you think of our proposed deficit funding policy?

- We understand that the current funding approach was over a fixed fifteen-year period from the date the established deficit was set. For GDNs this is the period 1 April 2013 to 31 March 2028. The exception would be where there is a significant established deficit towards the end of this fifteen year period, in which case Ofgem would look to fund that remaining deficit over a revised, but undefined, period beyond 31 March 2028.
- We understand that the proposed approach is to fund the established deficit over a fixed fifteen-year period from the cut-off date. However, any increase in this deficit which arises at a subsequent valuation will be reviewed, and if significant, could be funded over a longer period. This could re-extend the funding period to fifteen years from the date of the new valuation.
- There is a risk that the proposed approach could delay the scheme being fully funded on a technical provisions basis.
- Given WWU's interaction with tPR in respect of setting the deficit recovery plan for the 31 March 2009 deficit, we would look to Ofgem to provide flexibility of funding for the established deficit to match positions agreed with tPR, rather than being locked into a flat fifteen years recovery plan. Ofgem should consider the profile of the actual deficit recovery plan in funding the NWOs.

Q2. Do you agree that Ofgem's commitment to funding established deficits should be clarified?

- We agree with Ofgem that clarity over how significant deficits identified towards the end of the fifteen-year period ending 31 March 2028 will be funded and in particular the timeframe Ofgem considers appropriate, is beneficial.

3. Future focus

Q1. Do you agree with our suggested future focus for the reasonableness review?

- The NWOs have no ability to change accrued benefits earned in respect of past service. The pension scheme rules require that any changes that reduce member benefits (in respect of future service) require a two-thirds majority of the membership who are eligible to vote, to vote in favour of such changes.
- We do not agree that there should be increased focus on scheme administration expenses. This is a very small area of Totex spend within the RIIO price controls, representing less than 0.5% of Totex. Ofgem should consider whether any specific review is appropriate given the general principals of proportionality within the RIIO price controls.

- It should be remembered that administration expenses are part of allowed Totex (as is any ongoing Defined Benefit pension entitlement). Therefore NWOs are under the same pressures to minimise administration expenses as with all other costs within Totex.
- Future defined benefit pension accrual (after the setting of the established deficit) should also remain out of scope and continue to be dealt with as part of Totex. It is up to NWOs to appropriately incentivise their employees through the complete remuneration package.

Q2. What else, if anything, do you believe the reasonableness review should consider?

- The reasonableness review should consider the interaction between the funding of the established deficit under the fifteen year repayment plan established by Ofgem and the involvement of tPR. WWU has first hand experience of dealing with tPR in agreeing the 31/3/09 valuation. TPR rejected WWUs proposal of a flat lined recovery plan over fifteen years, and therefore WWU is funding the established deficit payments into the pension scheme in advance of the funding allowed by Ofgem, leading to a cash funding deficit within WWU. Such differences should be taken into consideration in setting deficit recovery allowances at future triennial valuations.
- Given WWU's interaction with tPR in respect of setting the deficit recovery plan for the 31 March 2009 deficit, we would look to Ofgem to provide flexibility of funding for the established deficit to match positions agreed with tPR, rather than being locked into a flat fifteen years recovery plan. Ofgem should consider the profile of the actual deficit recovery plan in funding the NWOs.

Q3. There is no Q3.

Q4. How do you believe the incentive and penalty mechanisms should work?

- We agree with Ofgem, it is difficult to see how a penalty régime would operate. Ofgem could instead:
    - Ensure that significant decisions made in respect of the pension scheme, and the established deficit in particular, are reasonable based on information reasonably available at the time, together with the advice of qualified advisors.
    - Consider what information it will require to make such value judgments and how onerous these requirements will be on NWOs.
    - Consider each pension fund separately. In particular, in respect of funding risk, what may be appropriate for one pension fund may not be appropriate for others.
    - Consider the relative maturity of the pension schemes – as an example, in 2005 when the sold GDNs acquired there pension positions along with the regulated businesses, they only had active employees, with no pensioners in payment or deferred pensioners. So it is likely that these schemes are less mature than the majority of other NWOs schemes and therefore there funding strategies may be different.

Q5. Do you believe there is scope to change benefits

- The NWOs have no ability to change accrued benefits earned in respect of past service. The pension scheme rules require that any changes that reduce member benefits (in respect of future service) require a two-thirds majority of the membership who are eligible to vote, to vote in favour of such changes.
- The Company will consider what member options could be introduced (to give members more flexibility in the shape and form of their benefits).

Q6. What support would NWOs need from us to encourage and support benefit and liability management exercised?

Following clarification, we understand that this question is asking what support NWOs would require from Ofgem in order to introduce benefit change and/or increase pension scheme liability management (through reduced risk or uncertainty for example)

- Ofgem supporting de-risking strategies which operate to the benefit of consumers as well as sponsoring companies and pension schemes.
- As it is unlikely that all possible scenarios will be envisaged in advance, flexibility is required from a supportive Ofgem, to reasonable requests.

4. Scheme approach to risk

Q1. How do you believe NWOs should approach setting (and advocating for) risk levels that best serve the interests of consumers?

- If NWO's do what's right (i.e. what an unregulated business with similar pension position would do given the information and advice reasonably available at the time), then Ofgem should be supportive.
- The general approach is that equity type returns reduce the amount of cash the sponsoring company is required to put into a pension fund. However, this approach can lead to funding volatility. Ofgem should therefore be supportive of investment strategies which offer equity type returns, but with lower risk. Such investment strategies to reduce risk whilst retaining an appropriate level of return are likely to change as pensions schemes mature.
- As set out above, because of the differences in the NWOs schemes, and in particular their maturity, the approach is likely to be different scheme by scheme; and this may result in outliers (for very good reasons) which are still to the benefit of consumers.

Q2. Do you agree with our comments on de-risking? Do you believe we need a different or more prescriptive policy?

- A more prescriptive policy will be difficult and likely to enhance "herding" of the NWOs which would be unlikely to minimize costs to the consumer.
- We should be aiming for appropriate de-risking strategies on a scheme by scheme basis. However, this requires a supportive Ofgem who will not use the benefit of hindsight in reviewing investment or de-risking strategies.
- Particular de-risking strategies may fail over time but be based on appropriate decisions using reasonably available information and expert advice at the time. In such circumstances the NWO should not be penalised. It may prove difficult for Ofgem to recreate the conditions at the date the decision was made, but in order to understand how a decision was made this needs to be attempted.

5. Stranded/trapped surpluses

Q1. What do you believe the likelihood of a stranded surplus occurring is?

- WWU believes that the likelihood of a stranded surplus is very low given the current size of deficits and the fact they have not reduced in spite of significant deficit contributions in recent years. Surpluses are only likely to occur if there are significant improvements in market returns above those currently being predicted in the technical assumptions (and which are derived from expert views of such future returns).
- Surpluses can only be identified as stranded once the scheme has closed and the last pensioner in payment has died. Reasonable estimates can be produced earlier and, based on these, deficit contributions can be adjusted accordingly.
- Surpluses measured against the technical provisions are unlikely to manifest in a surplus of cash in the scheme on its ultimate closure.

- As an example of approaches adopted to avoid stranded surpluses, WWU did not increase ongoing contributions following the 31 March 2012 triennial valuation even though the valuation required pension contributions to increase from circa 40% to circa 50%. Instead, as the 31 March 2012 valuation was performed at a time when real gilt yields were at an all time low, the company agreed with the Trustee to continue contributing at circa 40% and only pay the additional contributions to 50% should real gilt yields not have recovered as at the 31 March 2016 triennial valuation.

<u>Q2. What would be an appropriate measure for Ofgem to take if a stranded surplus occurs?</u>

- This would depend on how the surplus arose,
  - if through unexpected market movements, or revision to, say, longevity assumptions, then it would be harsh to penalise the NWO for circumstances beyond their control and which were not foreseen by appropriately qualified experts at the time.
  - However, if the stranded surplus arises through demonstrably poor stewardship then a level of penalty would seem appropriate.

<u>Q3. Would a formal policy on alternative funding arrangements be beneficial? If so, what form should this policy take?</u>

- A formal policy from Ofgem is likely to have some benefit. In particular, support for charges over regulated assets, which are currently prohibited from carrying charges under the NWO's license, would assist.

<u>Q4. Does Ofgem's existing pension allowance framework provide sufficient support for alternative funding arrangements?</u>

- No, NWO's are restricted by constraints within the license which prevent charges over regulated assets. Alleviating these constraints could assist in avoiding stranded surpluses.

6. Trustee role and the Pensions Regulator's expectations

<u>Q1. Does this correctly describe the trustee's role in relation to this framework?</u>

- The Trustees only have a responsibility to the members of the scheme, with guidance provided by tPR.
- WWU's experience is that Trustees have not been particularly interested in the allowances provided by Ofgem for deficit funding, but more in the wider concept of the company's ability to pay. More specific guidance from tPR for regulated businesses would be beneficial.
- In our experience, the Trustees have no direct interest in the impact on the consumer of the deficit recovery plan, they are more focused on the sponsoring company's ability to pay.

<u>Q2. Are the approaches of the two regulators sufficiently consistent to enable NWOs and trustees to agree scheme valuations and recovery plans?</u>

- Clearer guidance from tPR on how Trustees of regulated businesses should reach decisions on deficit recovery plans and phasing would be beneficial. Ofgem should continue to work with tPR to ensure explicit alignment.

7. Regulatory corporate governance

Q1. Do you have any comments on our proposed inclusion of pensions governance in the Statement of Regulatory Guidance?

- If the proposed pensions governance is aligned with our current license requirements, then the NWOs already have an obligation to report. If the expectation is above current obligations then it requires discussion as part of the separate consultation on RIIO accounts.

Q2. Do you believe this level of accountability will be effective in influencing NWOs' behaviour?

- We believe that there is already good tension between the Trustee on the one hand and the NWO and its shareholders on the other.

We trust that the above response is comprehensive and self-explanatory. However, should you require any clarification, please do not hesitate to contact us.

Yours sincerely,

Steve Edwards
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Wales & West Utilities