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

Report for Ofgem prepared by the Trustee of the National Grid Electricity Group of the ESPS

15th July 2015

Introduction

This report sets out the response from the Group Trustee of the National Grid Electricity Group of the Electricity Supply Pension Scheme to the Consultation on Ofgem's policy for funding Network Operators' pension deficits published on 21 May 2015.

Executive Summary

We are pleased to see Ofgem's encouragement to look at specific circumstances and the general move away from benchmarking networks against one another. We welcome the introduction of the opportunity to justify any deviation of approach from the norm which we believe is more likely to facilitate solutions that are appropriate for consumers and pension scheme members.

Trustees have duties under trust law and legislation. Our ultimate duty as trustees is to ensure that members' benefits are paid in full. Consistent with that ultimate duty is our fiduciary duty to act in the best financial interests of members.

We have a number of powers that help us achieve that including

- The power to set the investment strategy (in consultation with National Grid)
- The requirement (imposed by our Scheme rules and by the Pensions Act 2004) to negotiate and agree with National Grid a Statement of Funding Principles, a Schedule of Contributions and, where required, a Recovery Plan which define the contributions that National Grid will pay into the scheme

In exercising our powers and fulfilling our duties, we must have regard to trust law and legislation. We must also take into account guidance issued by the Pensions Regulator.

The exercise of the trustees' powers and our duties to pension scheme members are often aligned with those of National Grid and consumers but we believe there are significant areas where there are differences between Ofgem's approach and the Pension Regulator's approach in particular Ofgem's assumption that a 15 year recovery plan period is an appropriate valuation outcome for an employer with a strong covenant. Without additional security (e.g. alternative financing) we do not believe this is an appropriate assumption as it takes no account of the possibility of deterioration in that covenant.

We recognise the importance of the Employer's Covenant and the role of the Pensions Principles in supporting this. We believe that a healthy sponsor is an important part of our integrated funding, investment and covenant strategy, but we also are required to consider and plan for any worsening of the Employer Covenant in the future.

Chapter 1 – Reasons for Change

Question 1

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

Response

Although we acknowledge pensions are an important cost we do not believe that comparing the Established Deficit as at 31 March 2013 with the RAV is necessarily balanced. The Established Deficit or changes in the Established Deficit will not hit consumers' prices in one year, but will be recovered over a number of years.

Chapter 2 – Funding Period

Question 1

What do you think of our proposed deficit funding policy?

Response

We welcome the support provided by consumers for the Established Deficit as this does give members greater security. However, we are concerned about Ofgem's focus on 15 years and assuming that strong covenants necessarily lead to longer Recovery Plans.

Companies with a strong employer covenant have been shown to generally have a shorter than average length of Recovery Plan and the Pensions Regulator's analysis of Tranche 8 Valuations (22 September 2012 to 21 September 2013) shows strong employers with an average Recovery Plan length of 6.9 years.

We believe that 15 years can only be supported by the use of additional security. We currently achieve this alternative financing using a mixture of letters of credit and a charged account (escrow).

Question 2

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

Response

We support additional clarity regarding the funding of the Established Deficits after 31 March 2027. If 15 years is retained there are a number of areas of concern where we would wish to see further clarity for example

- *If the funding is on track, the ability to retain the existing Recovery Plan*
- *If funding is ahead of plan, to retain the existing Recovery Plan contributions recognising that full funding will then be reached sooner. This would be a symmetrical approach with the extension of Recovery Plans if funding is behind plan.*
- *If funding is behind plan, to retain the existing Recovery Plan contributions for the period required to meet the new deficit up to a maximum of 15 years, but not using the full 15 years if a shorter period will suffice. If the deficit is too great to recover it in this way then increased deficit contributions should start immediately, spread over 15 years.*

Chapter 3 – Future Focus

Question 1

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

Response

We note the future focus for reasonableness reviews. However we would like to point out that even if the Company believed that an action was in the best interests of consumers, if we did not believe it was in the best interests of members it would be our duty not to support it. Note that National Grid will need our co-operation to undertake action in a number of these areas for example because we are the data owners for the members' data.

The consultation does not specify what is meant by administration expenses. The Group Trustee carefully monitors its expenditure to ensure it receives value for money. We consider that an emphasis on cost cutting in the short term could lead to increased costs in the future from rectifying errors or sub-optimal outcomes due to the risks arising from poor governance and decision making.

Question 2

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

Response

No comment

Question 4

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

Response

We support judging actions based on their likely risks and returns and not penalising with the benefit of hindsight.

Question 5

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

Response

We manage the Group within the legal framework of trust law, legislation and regulatory guidance. We are required to deliver the benefits payable under the Scheme Rules and as trustees we have *virtually no scope to change benefits. National Grid, as employer, has some scope to change benefits or to manage liabilities but as noted below, this power is subject to limitations.*

Ofgem should note that

- *50% of our active members are Protected Persons under The Electricity (Protected Persons) (England and Wales) Pension Regulations 1990*
- *A further group of active members are protected by the 'no detriment' provisions in the Scheme Rules*

These protections, coupled with the trust law and statutory restrictions on making any adverse changes to accrued benefits, means that the Company's power to change benefits is limited.

National Grid has taken steps to manage liabilities by agreeing with members that pensionable salary should be capped. This was, however, achieved by variations to employees' terms and conditions of employment outside the terms of the Scheme rules. The trustees, on legal advice, are administering the scheme on the basis of these capped salaries.

We have discussed liability management with National Grid and we were not convinced that the exercises considered would be materially beneficial to scheme funding or scheme members compared to the costs of such exercises. The success of such exercises is dependent on there being an advantage to both the members and the sponsoring employer. Where members have few concerns over the strength of the employer covenant a significant incentive will be required to persuade members to give up the guarantees inherent in their DB pensions. There is no expectation that the benefits will be secured with an insurance company and hence there is no anticipated cost saving from liability management exercises. In future, we would evaluate the expected cost against expected benefit to members of any liability management exercise and would also need to consider legal advice.

Question 6

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

Response

No comment

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?

Response

Although we have the power to set the investment strategy in the Group we are required, and do, consult with National Grid on that strategy. However in our consideration we are focused on the level of risk appropriate for the members.

We suggest that the Pensions Regulator as representative of scheme members is another body that should be consulted when setting high level principles in relation to the level of risk appropriate for consumers' interests.

Question 2

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

Response

We have a plan to derisk the Group's investment strategy as the scheme membership matures. We believe it will be in consumers' interests for this issue to be managed and cease to be a material risk.

We support the approach of not using the benefit of hindsight to judge outcomes of any de-risking steps taken, as long as the decision was taken based on sound analysis of the situation.

We feel a more prescriptive approach would be contra to the comment "we continue to believe this is an area which is most appropriately considered by trustees and employer sponsors".

Chapter 5 – Stranded / trapped surpluses

Question 1

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

Response

The likelihood of stranded surplus occurring depends critically on the basis used to measure it. Surplus is quite likely to occur on a technical provisions basis but this does not mean that it is trapped or inefficient use of consumer funds. For example if a surplus occurs on a technical provisions basis this could be used to dynamically derisk and achieve the self-sufficiency state sooner.

We believe that surplus should only be considered stranded on at least a self-sufficiency basis or preferably a buy-out basis.

Although we have adopted an investment strategy which currently has the potential for significant upside performance, the intention is that any improvement in our funding level which is ahead of target will allow us to reduce the investment risk and achieve a smooth flight path to full funding which will avoid the risk of trapped surplus.

Question 2

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

Response

We believe Ofgem should encourage the avoidance of stranded surplus by allowing the costs of measures put in place to avoid stranded surplus to be passed through to consumers, recognising the benefits to consumers of this. Such tools include escrows (funding trusts or charged accounts), surety bonds, letters of credit or other alternative financing techniques. We do not believe that penalisation for stranded surplus should occur with the benefit of hindsight if exceptional conditions have led to the surplus.

Question 3

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

Response

We believe that the costs of alternative financing need to be recognised whether they are there to avoid stranded surplus or whether they are there to bridge the gap between an appropriate Recovery Plan length from a Trustee perspective and 15 years.

We do not consider a formal policy would be beneficial due to the variety of measures available to trustees to guard against a stranded surplus.

Question 4

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

Response

There has been concern regarding some previous alternative financing arrangements where the costs have not been allowed. Greater clarity on where costs will be allowed would provide appropriate additional support to encourage network operators to avoid stranded surpluses.

Chapter 6 – Trustee role and the Pensions Regulator's expectations

Question 1

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

Response

We are pleased that Ofgem have considered the role of Trustees and the Pensions Regulator. We believe that Ofgem may not have interpreted Pensions Regulator guidance appropriately. We do see employer covenant as an important part of the valuation process but do not think Ofgem has given sufficient weight to the long term risk of regulatory or political interference influencing that covenant strength. We disagree with Ofgem's conclusion that a strong covenant should lead to a longer Recovery Plan. We do not consider that 15 years is an appropriate Recovery Plan length.

Question 2

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

Response

We believe there are significant differences between Ofgem and the Pensions Regulator on the key point of length of Recovery Plan. This makes negotiations between company and trustees challenging when the company want to follow Ofgem's approach and the Trustees are mindful of their duty to members and the requirements of legislation and the Pensions Regulator's guidance.

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?

Response

In specifying the information to include, Ofgem need to consider that some information may be held by the pension scheme. It may not be consistent with our fiduciary duties to release this information to National Grid or Ofgem. For example, it is unlikely to be appropriate for us to pass information that we believe will adversely impact on our ability to robustly negotiate on contributions.

Question 2

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

Response

No comment