NATIONAL GRID UK PENSION SCHEME TRUSTEE LIMITED

National Grid House, Warwick Technology Park, Gallows Hill, Warwick, CV34 6DA
Telephone: 01926 65 4655

Private & Confidential
Eliza Twaddell
Regulatory Finance and Governance
Ofgem
9 Millbank
London
SW1P 3GE

15 July 2015

Dear Ms Twaddell

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

National Grid UK Pension Scheme Trustee Limited ('the Trustee' or 'we') is the trustee of the National Grid UK Pension Scheme ('NGUKPS' or 'the Scheme') which is the former British Gas pension scheme and which has assets of £17bn, with over 100,000 members; over 62% of whom are in receipt of a pension. Given its history, a significant amount of the liabilities in the NGUKPS relate to people who did not work in the National Grid networks business or its predecessors. As the trustee of a very large and mature pension scheme directly affected by your proposals, we are responding to this consultation in the interests of seeking to balance your goal of protecting consumer interests with our need to prudently ensure that all our members will receive the benefits due to them under the rules of the NGUKPS.

We agree with you that further clarification of Ofgem's policy with regard to funding established deficits is helpful for all parties. We fully appreciate your desire to protect the interests of consumers and set out our views how these may work with our fiduciary duties to members. A detailed response to each of the questions raised is set out in the Appendix. The key points are summarised below.

As you note, recent experience and, in particular, volatile and low gilt yields have led to increased scheme deficits and greater uncertainty about how these will progress in future. We therefore welcome your clarification that established deficits will be funded after the current 15 year period, if necessary. However, in assessing what future period for paying off deficits is appropriate, it is important to consider scheme-specific factors. Network business pension schemes vary in maturity and size, which has a bearing on the level of risk it is appropriate for each scheme to take and the measures it is appropriate for the Trustee to take to manage the risks of the Scheme. In this context, spreading new deficit over 15 years is too long for the NGUKPS. The NGUKPS is very mature and is currently paying out approximately £660m per year in pensions. Since 100% of pension needs to be paid out each year regardless of the funding level, the risks and consequences of not achieving full funding on the remaining liabilities in the medium term are significantly greater than they would be for a less mature scheme.

We also welcome support for de-risking strategies and the clarification that such actions will not be judged with the benefit of hindsight. We agree with you that it is in consumers' as well as members' interests for risk to be well managed to avoid volatility and large deficits in future. However, given the challenges around market timing of de-risking, we believe that the appropriate approach to de-risking may need to include both opportunistic and mechanistic elements, to ensure that as trustees we can meet our longer term funding objectives.

We agree with your assessment that the current approach to the GAD reasonableness review incentivises a convergence of behaviour/assumptions that may not be in the interests of schemes and their members, employers or consumers. As the largest regulated single company scheme, and one of the most mature, we believe a scheme-specific approach which focusses on the overall package agreed between the Company and Trustee is the appropriate way forward.

As you note, trustees need to manage their schemes in accordance with the legislation, fiduciary duties and the guidance from the Pensions Regulator. We would strongly encourage Ofgem and the Pensions Regulator to work together to ensure clarity for trustees and companies and an alignment of the regulatory frameworks. This is particularly relevant for deficit recovery periods, where the Pensions Regulator would generally expect strong companies to fund a deficit over significantly less than 15 years. It is also relevant to the level of investment risk in the NGUKPS. For a very mature scheme, the Pensions Regulator's expectation may well be that the scheme should be significantly de-risked.

While NWOs need to have regard to the impact of their decisions on consumers, this is not formally the role of the trustee (other than indirectly as part of its assessment of employer covenant). The consultation suggests that trustees should take the impact on consumers into account because *"the employer's plan for sustainable growth will include their duty to consider the needs of consumers"*. The Pensions Regulator's Code of Practice generally refers to *"sustainable growth"* in the context of the trustee and employer needing to decide whether, and to what extent, investment by the employer in its business should be prioritised over deficit contributions to its pension schemes. There is not a direct link between this issue and the employer's duty to consider consumer interests. We therefore are unclear whether the Pensions Regulator would agree with your interpretation of sustainable growth.

Any misalignment on the issue of the extent to which trustees should (indirectly) consider consumer interests will lead to conflicting regulatory requirements on trustees and risk inefficiencies and additional costs. In any event, it is worth pointing out that from a legislative perspective having regard to the sustainable growth of the employer is a requirement for the Pensions Regulator, in its approach to regulating the funding arrangements of defined benefit schemes. There is no legal requirement on trustees to directly take into account employer's sustainable growth objectives when making decisions on funding. The existing legislation and regulation of pension schemes means that trustees are already required to efficiently manage their schemes, to de-risk and to address deficits over appropriate timescales in a manner agreed with the employer. There is therefore a good natural alignment with consumers' interests without the proposed additional and potentially conflicting regulatory burden of asking trustees to take into account Ofgem's interpretation of sustainable growth.

Furthermore, we do not believe it is within the remit of the Pensions Regulator *"to guide trustees as to how they might take NWOs' consumer advocacy into account"*, since it is not directly relevant to trustees and is also not relevant to the objectives of the Pensions Regulator. As noted above though, there is still something to be gained from the Pensions Regulator issuing more practical guidance as to how its approach (for example, encouraging shorter Recovery Plans where possible and encouraging de-risking where appropriate) can better fit with Ofgem's approach to funding established deficits and we will be writing separately to the Pensions Regulator in that regard.

I, and some of my fellow trustees, would be very happy to meet with you should you wish to discuss further any of the points we are making in this consultation response.

Yours faithfully

Nigel Stapleton
Chairman of the Trustees of the National Grid UK Pension Scheme

Appendix

Chapter one

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

For the NGUKPS, the pension scheme assets at £17bn are actually greater than National Grid Gas's RAV. The exposure to the Scheme is therefore a very significant factor for the Company's cost of capital. We believe that the clarification of the position on funding after 15 years is helpful in protecting against adverse capital impacts. We are also of the view that encouraging schemes to de-risk as appropriate, for example by putting in place interest, inflation and longevity protection, will be a significant protection against future adverse capital impacts on the sponsoring employer, as well as being of benefit to consumers in the longer run.

Chapter two

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

We have not seen any evidence of the behaviour you suggest – in particular, a desire for *"excessive prudence"* on behalf of either the Trustees or the Company. However, we welcome the clarification that established deficits that persist over 15 years will be funded, and agree that deficit recovery periods should not be set by reference to an arbitrary date. For a scheme as mature as ours however, a 15 year benchmark is too long. The NGUKPS has to continue to pay 100% of pensions each year even though it is not fully funded, which dilutes the asset cover for the remaining liabilities and adds extra pressure to get sufficient returns on the remaining assets – a situation in which this undesirable position persists for a long time (or indeed worsens if the annual recovery payments are initially not even sufficient to keep the Scheme at its current funding position) unfairly disadvantages future pensioners (almost all of whom will have pre2013 service and should therefore be afforded equivalent protection) when compared with current pensioners.

We would also note that a 15 year Recovery Period is significantly longer than for a typical UK pension scheme with a strong employer, and longer than the Pensions Regulator would typically expect.

The Trustees of the NGUKPS have a longer term objective to reach full funding on a sufficiently prudent basis by between 2025 and 2029. This is not driven by Ofgem's regulatory timeframe but instead by the maturity of the NGUKPS and the impact of market volatility on a scheme which has to make very substantial annual pension payments. The proposed 15 year time period is inconsistent with this objective and would therefore be very difficult for the Trustee to agree to.

Whilst we understand Ofgem's concern will be the protection of current and future consumers, Ofgem should also recognise that the deferred pay obligations which NWOs have under schemes such as ours will have often arisen before the current regulatory regime for the gas industry was established and consumer interests were prioritised.

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

Yes, although as noted above scheme-specific factors should be taken into account.

As you rightly note, recent experience and, in particular, volatile and low gilt yields have led to increased scheme deficits and greater uncertainty about how these will progress in future. We therefore welcome Ofgem's clarification that established deficits will be funded after the 15 year period, if necessary. However, in assessing what future period for paying off deficits is reasonable, it is important to consider scheme-specific factors. Network business pension schemes vary in maturity and size, which has a bearing on the level of risk it is appropriate for each scheme to take and the measures it is appropriate for the trustee to take to manage their risks. It is in consumers' as well as members' interests for risk to be well managed to avoid volatility and large deficits in future. For example, the fact that the NGUKPS is very mature and currently paying out approximately £660m per year in pensions means the risks and consequences of not achieving full funding in the medium term are significantly greater than they would be for a less mature scheme. A 'one size fits all' approach is therefore not appropriate. For the NGUKPS a 15 year Recovery Period is too long.

Chapter three

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

We support the goal of a more nuanced and flexible role for the reasonableness review, and agree that the current review is focussed on issues which are the primary responsibility of trustees and regulated by the Pensions Regulator. As noted in Question 2, we also believe that a scheme-specific approach is needed so that the reasonableness review properly takes into account the circumstances of each scheme in determining what *"efficiency"* means in the context of that scheme. For example, for a very mature scheme a de-risked investment strategy may well be the most efficient approach, as it will lower the risk of very bad future funding outcomes, but a less mature scheme may be better able to manage investment volatility and hence a relatively higher risk strategy may be considered more efficient for such a scheme.

You state that the ongoing focus of the reasonableness review should be on issues which are more under the influence of the NWOs, which we understand and fully support. However, we also understand that future service benefits are not in scope for these reviews. Furthermore, legislative protections for accrued benefits together with the restrictive amendment powers within the Scheme rules mean that there is very limited scope for any changes to benefits that would impact the size of the established deficit.

Liability management exercises may need to be quite generous to get good take-up rates and can therefore be limited in the savings that can be achieved relative to a scheme's ongoing funding position. They also rely heavily on very clear communication and comprehensive independent financial advice for members. Again, the impact of restrictive amendment powers may be relevant here. In summary, we believe that such liability management exercises will be very difficult to implement and are likely in practice to lead to very little reduction in established deficits.

We understand and agree with Ofgem's concern that ongoing administration fees are well managed and controlled, but would note that they make up approximately 4% of total annual cashflow and in our view do not warrant heavy scrutiny from Ofgem. Furthermore, we question the extent to which they are under company rather than trustee control. Trustees are already required by their existing statutory and fiduciary duties to balance the costs and risks of pension administration provision. In any event, for the NGUKPS, the Company provides administration services to the Trustees and is already therefore incentivised to keep administration efficient.

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

To align with the approach taken by trustees and the Pensions Regulator, the reasonableness review should focus for each scheme on the overall valuation 'package' that has been agreed between the company and the trustee; in particular, on whether an efficient outcome has been achieved which balances company, consumer and member interests in the decisions made on technical provisions, the reliance on future company contributions compared with reliance on investment risk to fund shortfalls and in Recovery Plans of appropriate magnitude and duration.

Question 4: How do you believe the incentive and penalty mechanisms should work?

No comment

Question 5: Do you believe there is scope to change benefits and engage in constructive liability management?

As noted in our response to Question 1, we think there is very limited scope for either of these activities to have a material impact on scheme deficits (unless such exercises result in members being provided with materially lower value benefits in exchange for the benefits given up, which would not be appropriate). In particular, many of the NGUKPS's members are older pensioners in receipt of small pensions. Asking such members to make decisions, for example, on the nature of the future pension increases, is unlikely to be appropriate or to result in large savings to the Scheme.

Question 6: What support would NWOs need from us to encourage and support benefit and liability management exercises?

It would be very important that NWOs consider liability management exercises in the round and take account fully of industry and Pensions Regulator guidance in these areas, to ensure such exercises are undertaken responsibly and with full and detailed member communications. We see limited benefit of such exercises for the NGUKPS, given its profile.

Chapter four

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

You note that you expect NWOs to account for how they have taken the best interests of consumers into account when setting levels of risk, particularly investment risk.

NWOs are consulted on investment strategies, but are not the decision makers. While the NGUKPS Trustees work hard to ensure a collaborative approach with the Company on investments and believe this is in everyone's interests, it is important that Ofgem recognises that it is trustees and not the NWOs who ultimately set the investment strategy. NWOs should not be penalised if, after consultation, trustees choose to follow lower risk strategies which they believe are most appropriate for their scheme membership.

As noted previously, for trustees the impact on consumers is not directly a relevant factor in their investment decision-making. In any event, even experienced trustees find the process of setting investment risk challenging. Trustees also have a duty to take and consider professional advice and it is difficult to see how trustees could fully exercise this duty and also demonstrate taking into account input from consumers and consumer interest groups who do not have investment specialism and are not financially regulated. Also, what is in the best interests of individual consumers will differ. An older consumer may prefer a higher risk investment strategy that results in low costs in the short term. A young consumer may prefer a lower risk strategy (even if it means higher costs in the short term) if it means these costs are likely to be more stable in future and it therefore reduces the risk of volatility in investment markets causing significant deficits (and hence big cost increases) in the medium to long term.

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

We welcome Ofgem's support for moves towards de-risking.

We agree that moves towards de-risking are appropriate to shareholders', consumers' and members' interests as they will lead to stable, better funded schemes over time. We have a long term aim of reaching full funding on a low risk basis, and would like to be able to use a combination of mechanistic and dynamic approaches to achieve this goal. While we agree that inflexible de-risking approaches are unhelpful, it is notoriously difficult to identify genuine market opportunities, and such opportunities may be short lived. Therefore a combination of dynamic and mechanistic approaches is in our view the most efficient way to achieve a satisfactory outcome in the longer term.

We would not be in favour of a more prescriptive policy, as we think the regulated schemes are sufficiently diverse that such prescription may not be appropriate for all schemes under review.

Chapter five

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

We do not believe there is a material risk of stranded surplus in the Scheme. We already have contingent funding arrangements in place to mitigate this risk. Furthermore, our deficit on a low risk basis (and even more so on a solvency basis) is substantial relative to the contributions being received, and therefore it is very unlikely there will be a surplus on either of these measures for many years. Improvements in funding relative to the technical provisions will however provide a much hoped for opportunity to further de-risk the Scheme (thus benefitting future consumers through greater stability of pension costs) and therefore not create 'stranded surplus'. We therefore do not see stranded surplus as a likely possibility for the foreseeable future for the NGUKPS.

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

As noted above, we believe the risk of stranded surplus is low. Any stranded surplus, if it did occur, would most likely be caused by significant unexpected market movements, or exceptionally successful investment strategies. It would not be appropriate for Ofgem to penalise NWOs in either of these circumstances.

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

We do not believe this is necessary, but have welcomed the flexibility to put in place alternative funding arrangements which can work from both the company and trustee perspective.

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

No comment.

Chapter six

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

We are pleased that Ofgem recognises that it does not regulate trustees and that trustees already have a detailed framework for decision-making and behaviour. We are also pleased that Ofgem is supportive of the approach outlined in the revised Code of Practice on funding. However, we remain to be convinced that the employer's plan for sustainable growth includes their duty to take into account the impact of pension funding arrangements on consumers. In any event, impact on sustainable growth is actually a concern for the

Pensions Regulator itself. There is no legislative requirement for the employer's sustainable growth prospects to directly impact trustees, and it is not the trustee's role to directly balance the needs of consumers against the needs of members of the scheme.

The consultation correctly describes a number of statements in the Code of Practice, but is silent on other aspects of the Code which will be fundamental to the trustee's approach. For example, integrating funding, covenant and investment risks, fully understanding downside risks faced by the scheme and putting in place plans to manage and mitigate such risks (such as reducing investment and longevity risks). The Pensions Regulator is also clear in its policy framework that covenant strength should not be double counted – for example, if a strong covenant is used to justify weaker than average technical provisions, it should not also be used to justify a long recovery plan. This means that weaker than average technical provisions which recognise the strength of the employer covenant would not be compatible with a 15 year recovery plan.

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

We believe some aspects of the approaches of the two regulators are not entirely consistent, for example recovery plan lengths and the extent to which schemes should de-risk. We note your intention to work with the Pensions Regulator to develop clear guidance for trustees and employers. We would welcome further dialogue between the two regulators to clarify their positions and we will be writing separately to the Pensions Regulator to encourage this, although we would also note that it is the trustee's legal and fiduciary duties, rather than the position of either regulator, that are paramount in the trustee's decision-making processes.

Chapter seven

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

No comment

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

No comment