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Eliza Twaddell
Ofgem
9 Millbank
London
SW1P 3GE

Lane Clark & Peacock LLP

95 Wigmore Street
London
W1U 1DQ
Tel: +44 (0)20 7439 2266
Fax: +44 (0)20 7439 0183

www.lcp.uk.com

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Dear Eliza

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

**I am writing on behalf of Lane Clark & Peacock LLP in response to the above
named consultation dated 21 May 2015.**

Lane Clark & Peacock LLP ("LCP") is a firm of financial, actuarial and business consultants, specialising in the areas of pensions, investment, insurance and business analytics. LCP is regulated by the Institute and Faculty of Actuaries in respect of a range of investment business activities.

We advise the trustees and employers of a range of regulated industries, including the regulated energy network operators' sector, on pension matters. Also, LCP's energy analytics team provides specialist advice in the analysis and modelling of electricity markets. This response reflects the combined views of a number of LCP consultants.

We welcome the consultation and the intention to give greater clarity to Ofgem's position regarding how it will support pension scheme trustees and employers working together to deliver pensions in a cost effective way for consumers and other stakeholders.

In particular, we:

- welcome the acknowledgement that funding the established deficit with a hard deadline of 15 years from the relevant cut-off date might push NWOs and trustees to more cautious funding and investment policies than current consumers might

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hope for. We agree that providing clear guidance confirming that contributions for established deficits can be recovered beyond the end of the original 15 year period could help to mitigate this. We would welcome further clarity for NWOs on what timescales may be acceptable for the pass-through contributions, including any further guidance on how the NWOs may demonstrate that they have reflected the consumers' interest into their submission;

- are very supportive of trustees and NWOs working collaboratively together, but also welcome the acknowledgement by Ofgem that they have different obligations to different parties. When it comes to a UK defined benefit pension arrangement, it is the trustees who are responsible for the management of the arrangement and their primary concern is to ensure pension scheme members receive the benefits promised; and
- would agree that having a mechanism to see any trapped surplus (calculated on a buyout basis) after the Scheme has been wound up returned to consumers in a sensible way would give NWOs and trustees greater flexibility on funding and investment, whilst continuing to protect consumers. In particular it would reduce the concern of NWOs that deficit payments made would not ultimately be needed and reduce the risk that, with hindsight, they could be criticised and potentially financially penalised for having overpaid into the pension arrangements. However, we appreciate that it is only likely that this can be achieved by legislative change. In practice existing mechanisms for managing assets and liabilities can be effectively used (with strong governance) to manage and minimise the risk of trapped surplus emerging on a buyout basis, but there can be costs attached to these mechanisms.

Our answers to the questions (which we have grouped together) can be found in the Appendix.

Yours sincerely

 Prepared as an attachment to an email
at 16:25 on 15 July 2015

Chris Bunford FIA
Senior Consultant

Direct tel: +44 (0)1962 872765
Email: chris.bunford@lcp.uk.com

Section 1 - Reasons for change (Question 1)

We welcome Ofgem reiterating the commitment to consumer funding of the established deficits.

Underlying the consultation, it is clear that the size and financial significance of the liabilities and potential long term costs to consumers of meeting the benefits built up is recognised by Ofgem. While leaving NWOs and trustees to determine the strategy for managing the liabilities, our interpretation of the direction of Ofgem's expectations is that it:

- expects the funding target trustees should ultimately be aiming for in most cases is the cost of buying out the established scheme benefits in full with an insurer and then removing the liability from the NWO balance sheet. This would be in line with the long term plans of a growing proportion of sponsoring employers and trustees of schemes outside the regulated sector; and
- recognises that current financial market conditions and in particular bond yields mean that for many schemes this target is potentially some decades away (unless current consumers are required to pay significantly greater contributions in the short term, which would see a potentially undue burden on them over the next few years).

If this is the case, then it would be helpful for Ofgem to confirm this.

On the basis of that understanding then, broadly, we see the measures proposed in the consultation document as helping clarify the commitment of Ofgem to fund established deficits.

We see the proposed measures as a helpful step towards minimising any impact on cost of capital from movements in the funding positions of defined benefit pension schemes, which is your stated aim. Any additional clarity that Ofgem can provide on pensions matters in its final determination is likely to further help to achieve this goal.

In section 1 you specifically identify equity risk but the logic applies to all the unhedged risks being run in pension schemes. The commitment means that NWOs and trustees can balance the costs and benefits of hedging specific risks on their financial merits, rather than having their decision-making distorted by non-financial constraints.

Section 2 – Funding period (Questions 1 and 2)

We agree that limiting the period over which NWOs can recoup deficit contributions to an inflexible 15 years from the cut-off date may well strongly push NWO's and trustees towards early complete risk-reduction in respect of the established deficits, leading to

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higher funding targets being set earlier, and higher deficit contributions to support this strategy. This may well not be the optimal approach for all parties involved.

Appendix (cont)

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The economic circumstances that will apply over the coming decades are unknown and it may be that, with hindsight, the lowest long term cost solution for consumers would have been early funding of the deficit. However, as a general principle we would expect better outcomes when the decision-makers can make choices based on specific financial circumstances rather than choices driven by arbitrary non-financial deadlines.

It should be noted that the established deficits relate to historic pensions accrual, so any potential extension of the time taken to pay off deficits will mean that the cost of meeting the historic liabilities will be passed on to future generations of consumers who are even more disconnected from those accrued liabilities.

A residual concern of trustees will be that a change to the regulatory regime could see a weakening of the covenant and introduce a risk that members do not receive their benefits in full. The trustees have a duty to members, rather than to consumers. This, and the requirements under pension legislation for trustees to take a prudent approach, will mean that trustees may well want to reduce deficits more quickly than other stakeholders.

A deficit funding period of 15 years is considerably longer than for an average UK defined benefit scheme (based on the Pensions Regulator's figures). It may therefore be helpful for the Pensions Regulator to issue new guidance setting out how it expects trustees can reflect the additional covenant of consumers backing the established deficit.

It would also be helpful for Ofgem to acknowledge that deficit recovery periods are subject to negotiation between the NWO and the trustees and to confirm that in practice they may be funded over shorter or longer periods than the pass-through period.

Whilst in our experience trustees are fully aware of the additional covenant they benefit from compared to the non-regulated sectors, we are aware the Pensions Regulator's lack of clarity means that trustees may decide it is appropriate to be more prudent in their approach than could otherwise be the case. There also remains the possibility that the Pensions Regulator's statements or behaviour at some future point pushes the trustees to a more cautious approach. This risk can be reduced by Ofgem working with the Pensions Regulator, which we encourage (see our response to section 6).

Section 3 – Future focus (Questions 1 to 6)

We agree with the principle that future reviews should concentrate on those areas which are within the influence of NWOs and that the current process of benchmarking risks a mentality that focuses on staying close to the average of peers, rather than taking action to address the specific circumstances of each NWO and its pension arrangements.

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We support the intention not to penalise with the benefit of hindsight adverse outcomes for consumers if decisions were reasonably made.

Appendix (cont)

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A range of liability management steps are now available to, and increasingly used by, employers and trustees, and these can be applied to NWO's pension arrangements. Concerns about the risks of these exercises for members, trustees and employers led to the creation of the Code of Practice for Incentive Exercises, which is currently being reviewed in light of the DC freedoms and flexibility that were introduced in April 2015 <http://incentiveexercises.org.uk/the-code-of-practice>.

The financial attractions of such exercises need to be balanced against the cost and longer terms risks of the exercises. Each NWO and set of trustees would need to consider these based on their specific circumstances.

We note the intention to monitor scheme administration expenses. In our view any such monitoring needs to acknowledge that good governance is essential to manage pension scheme risk. For example, it is crucial that any liability management exercises are based on fully accurate data, are well managed and properly communicated, including in many cases the provision of financial advice to pension scheme members. Administration expenses therefore need to be considered in the round, rather than looking at headline numbers in isolation.

Section 4 – Scheme approach to risk (Questions 1 and 2)

The scheme approach to risk is a significant issue for trustees as well as NWOs. Whilst NWOs will be negotiating for good outcomes for consumers it is useful that the consultation alludes to the fact that they have no absolute right to change the scheme's approach to particularly investment risk. In particular, section 35(5) of the Pensions Act 1995 states that:

(5)Neither a trust scheme nor a statement of investment principles may impose restrictions (however expressed) on any power to make investments by reference to the consent of the employer.

That being said, we strongly support trustees and NWOs working together to set an appropriate investment strategy.

It is important to appreciate that opinions on what risk is and how best to mitigate it can legitimately vary depending on circumstances in each case. There are no single right answers for all schemes in this area.

We are certainly in favour of the principle of ensuring adverse outcomes are not penalised if they result from decisions that were reasonably made. The explicit comment that the proposal is not to judge outcomes of de-risking with the benefit of hindsight is particularly helpful.

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We will leave it to others to comment on the specifics of collecting and then reflecting the views of consumers. We note that shareholders who bear the costs of deficits in non-regulated entities are increasingly supportive of de-risking, and one might expect stakeholders in NWOs to have a similar outlook.

Appendix (cont)

Section 5 - Stranded/trapped surplus (Questions 1 to 4)

We agree with the analysis that there is a mismatch of incentives, with consumers standing behind deficits but potentially not benefiting if surplus arises.

However, for funding on an ongoing basis (ie anything up to a full buyout basis), unexpected positive experience can be used to reduce risk, which is a benefit to consumers. In our view Ofgem should measure any surplus in this context as being a surplus relative to the cost of fully securing the benefits of the Scheme with an insurance company.

There remains the risk that there are surplus assets left once benefits are insured in full and that there is no mechanism to return those funds to consumers. There are now mechanisms available through investment triggers and an ability to lock-in insurance terms that enable trustees and employers to minimise the risk of material trapped surplus on this basis. These are widely used in the non-regulated sector. We therefore see this as primarily an issue of ensuring good governance.

Alternative funding arrangements, such as escrow accounts or special purpose vehicles, can help reduce the likelihood of a trapped surplus but, depending on their design, they can be expensive to implement and then maintain over long periods. If an alternative funding arrangement is an appropriate and cost-effective solution, NWOs should not be penalised for running up reasonable administration costs in their implementation.

A possible solution to concerns about trapped surplus would be a legislative one, allowing the trapped surplus to be returned to consumers. If that could be achieved it would give all parties greater confidence in managing the schemes. Alternatively, as mentioned above, contributions could be paid into vehicles such as escrow accounts which might allow the NWO (and ultimately the consumers) the opportunity to access the funds if they end up not being needed to meet pension obligations.

We observe that, ultimately, securing pension benefits with an insurance company is likely to be a good outcome for consumers. This likelihood of NWOs running up a significant surplus relative to the cost of buyout in the near future appears limited at the present time; however when planning for the long term it is of course important to seek to minimise the systematic risks of trapped surpluses emerging.

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Section 6 – Trustee role and the Pensions Regulator’s expectations (Questions 1 and 2)

Appendix (cont)

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As noted in our response to section 4 the running of the pension scheme is the trustees’, rather than the employer’s, duty. It is helpful that the proposals acknowledge this.

In recent years, the UK Government and the Pensions Regulator have sought to incorporate the needs of sponsoring employers more into the funding process and to minimise any adverse impact on their sustainable growth. There has been a welcome shift towards encouraging more collaborative working between trustees and employers, rather than generating artificial conflict.

However, in our view section 6 arguably overplays the trustees’ duty to the consumer.

The position where the costs of deficit contributions are passed directly to consumers differs from cases where the company itself pays the contributions eg from its own profits. Trustees and NWOs can agree appropriate investment strategies and schedules of contributions in a collaborative fashion in most cases. However, under the current legislation, the trustees have the ability (and potentially the duty) to consider the interests of scheme beneficiaries ahead of consumers.

As noted in earlier questions, specific guidance from the Pensions Regulator setting out how it expects trustees to behave in this environment could help all parties. Although not changing any legal duties on trustees, Pensions Regulator guidance would help trustee decision-making processes.

Section 7 – Regulatory corporate governance (Questions 1 and 2)

Given the difficulty in holding NWOs accountable for trustee decisions, we agree that financial penalties are not appropriate.

The governance solution therefore looks the appropriate way to encourage NWO engagement. The focus should be on generating positive outcomes, rather than generating additional bureaucracy with no benefit to stakeholders.