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Dear Eliza,

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

This letter sets out our response to Ofgem's consultation on funding of Network Operator's (NWO's) pension deficit. We welcome Ofgem's intention to clarify their approach to assessing NWO's pension deficits and the related allowances.

Ofgem's reinforced commitment to fund established deficits through the pension principles is a welcome confirmation. We agree that the previous approach Ofgem employed for determining and adjusting allowances for pension deficit repair payments through assessing valuations for 'outliers' is not an effective methodology whereby it suffers from assessment deficiencies. We also believe it introduced a level of risk to NWOs whereby allowances could be materially lower than actual deficit repair payments unnecessarily which was subject to adjustment every three years. We are however cautious about the commitment to fund beyond the initial notional 15 year funding period set previously by Ofgem. As long as schemes are performing in line with expectations, we believe there should be no reason for extensions and these should only be considered where material changes have arisen in the deficit since the initial established deficit was set.

Although we welcome the clarity Ofgem's has sought to outline in the consultation for funding NWO's pension deficits, we believe there still resides a degree of ambiguity and uncertainty around how its proposals will be achieved in practice. We would strongly advocate for Ofgem to engage in further dialogue with NWO's, pension trustees and the Pensions Regulator (PR) to ensure effective and fair implementation of their proposals. We believe Ofgem should provide clarification and guidance as opposed to prescribe a restrictive policy in their approach to pensions.

We have outlined our views of appropriate considerations as Ofgem's pensions policy develops:

- We would advocate a multilateral approach inclusive of all relevant stakeholders throughout the development of Ofgem's pensions policy, particularly when discussing proposals with the PR around how trustees will consider consumers in practice;
- Transition the pensions reasonableness review to a consultative bilateral dialogue whereby NWOs provide a triennial pensions report outlining how they have sought to protect consumers in their approach to pensions;
- Continued utilisation of a Government Actuarial Department (GAD) style report to provide background and contextual information to Ofgem, **not** to identify 'outliers' and make arbitrary adjustments on NWOs. This would require information from NWOs although we would propose a simplification of the Regulatory Reporting Guidance for Pensions and associated Pensions Deficit Allocation Methodology (PDAM) submissions

- A greater understanding of how Ofgem will assess differing de-risking strategies of individual schemes without introducing the problem of '*hindsight bias*';
- Ofgem's view of differing funding periods for individual schemes and how these will be funded through regulatory allowances;
- The intentions to create effective and fair incentives to encourage NWO's to act in the interests of consumers and **not** penalise outcomes, and how this will be applied in practice; and,
- Clarity regarding company requirements to comply with the Regulatory Business Governance in the context of pensions and future implications.

Formalisation of an annual pensions review meeting bilaterally between Ofgem and NWOs is a necessary step in ensuring these points are developed and understood and will provide a suitable forum to discuss developments in the scheme and in general across the industry. These meetings will provide a forum for feedback in between reasonableness reviews. This will ensure the funding is in the interest of all stakeholders, including consumers;

We have set out the detailed response to the consultation questions in the appendix to this letter and would be more than willing to discuss our views further to help inform the development of Ofgem's pensions policy.

Yours sincerely

Mike Bedford  
SGN

## Appendix

This appendix sets out our detailed response to the consultation questions in the consultation document.

### Section 1 – Reasons for change

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

Although we welcome Ofgem's proposed change to pension reasonableness review in principle, we believe it requires further clarity and definition. We believe that Ofgem's views proposed in the consultation fundamentally represent the existing framework on pensions, whereby the pension's principles and triennial reasonableness reviews continue. As a result, we have no reason to believe the level of risk differs under these new proposals, meaning the impact of pension risk on the cost of capital will remain the same now as in previous price controls.

### Section 2 – Funding period

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

We remain cautious on Ofgem's proposal to accept funding periods greater than the original 15 years in the pension principles. We note the reasons set out in the consultation and believe extensions should only be considered if there have been material changes in the deficit since the established deficit was set. Consultations should take place where Ofgem and / or the Trustees consider extensions are in the interest of all stakeholders. There may be certain circumstances where a shorter repair plan is more effective when linked to a clear de-risking strategy that will ultimately protect funding and avoid greater contributions in future, thereby protecting consumers.

We believe any assessment of NWO behaviour and scheme management should be considered 'in the round'. Ofgem should avoid penalising 'outliers' when assess de-risking strategies, members benefits, liability management, pay awards, and funding periods in isolation. We also would be concerned that any assessment may contradict Ofgem's commitment to "assess the actions of NWOs in protecting consumers, not penalising results".

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

We believe that maintaining a clear, simple, and consistent funding commitment facilitates Trustee boards and companies to agree sensible funding plans that also work for consumers and other stakeholders. We would advocate further clarity on the implications of various funding periods and the simple practical implementation of regulatory funding.

For example, in broad terms it appears that a variety of deficit repair periods for established deficits would be appropriate if justified, for example extending deficit repair period if further material deficits arise either additional funding years for the additional deficit, via re-profiling or simple extension of the funding period. What would be the proposed approach if shorter deficit repair periods are agreed as part of a 'holistic' agreement on the scheme valuation and funding plan amongst other important elements?

### Section 3 – Future Focus

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

We are supportive of a reform to Ofgem's pension reasonableness review and in principle are supportive of a more 'holistic' approach. The previous approach resulted in unfair and adverse adjustments through inappropriate benchmarking of schemes which have distinctly different characteristics.

We have outlined our thoughts on incentives/penalties in response to the relevant consultation question below.

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

We believe Ofgem should be mindful of their commitment to assess actions of NWOs in protecting consumers, not penalising the results. In the spirit of this, behaviour and considerations of NWOs is more critical to any reasonableness review instead of mechanistically reviewing decisions and outcomes. Given there are constraints on NWOs to change member benefits and liability management can be deemed uneconomical, it is important that Ofgem recognise these in the approach to the pension reasonableness review.

The focus for a reasonableness review should not extend beyond NWO behaviour, and decision reached for scheme specific funding and investment strategy should be considered 'in the round' and was appropriately taken to balance risk, return and the cost to consumers at that time.

*Question 3 (nee 4): How do you believe the incentive and penalty mechanisms should work?*

At this stage, it is difficult to determine what the appropriate incentive and penalty mechanisms should be given there is still a lack of clarity around how Ofgem will implement future pension reasonableness reviews in practice. We do not believe simulating changes to valuations and funding periods is appropriate as a penalty since this is a penalty on decisions and not behaviour/actions of NWOs. However, we remain open to discuss appropriate incentive frameworks focused on NWOs behaviour and actions in protecting consumers and the process develops in the future. As such, we strongly believe further engagement and discussions is required to develop any mechanisms to ensure they encourage the desired behaviour effectively.

*Question 4 (nee 5): Do you believe there is scope to change benefits and engage in constructive liability management?*

There is always merit considering options to limit or control benefit costs within the current constraints and assessments should extend to the wider benefits package offered by NWOs. We believe there is a judgement required regarding the likely net cost or benefit of implementing any changes to benefits or liability management that must be considered at the time of the decision.

Examples of factors under consideration but not limited to are ongoing employee relations, operational implications, wider pay and benefits, staff retention, and the impact on consumers.

We believe that NWOs should seek to manage the net costs on behalf of consumers while remaining aware of developments in defined benefit pension schemes across other industries. This is where annual pensions update meetings between Ofgem and NWOs would be beneficial and help inform Ofgem of ongoing developments, actions and behaviours of NWOs without being overly onerous or prescriptive.

*Question 5 (nee 6): What support would NWO's need from us to encourage and support benefit and liability management exercised?*

We would advocate clarification as outlined in the body of this letter and detailed responses to the consultation questions as the necessary action required by Ofgem. Additionally, consideration of additional allowances for feasibility studies and related implementation costs for any action taken by NWOs to manage liabilities and benefits. We would also advocate Ofgem adopt a scheme by scheme assessment of any initiative to manage liabilities or amend benefits instead of a cross industry application through inappropriate benchmarking. Ongoing review of industry wide initiatives should always be considered as scheme specific and not necessarily applicable to the NWO schemes.

#### **Section 4 – Scheme approach to risk**

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

As Ofgem note in the consultation, “this is an area which is most appropriately considered by trustees and employer sponsors” and therefore we do not see an active role for consumers or Ofgem to approve or evaluate decisions regarding the level of risk adopted in a particular scheme. We believe any assessment of this nature would result in hindsight bias, whereby some schemes would be deemed to be successful or not depending on the outcome of their decision. This would be contradictory to Ofgem's commitment and we would advocate that Ofgem approach de-risking evaluation based on the behaviour of NWOs and their actions and not the outcome of decisions which are outwith their control.

Again, any consideration of the level of risk depends on each scheme's characteristics and is difficult to be benchmarked fairly without inadvertently reverting back to 'outliers' which Ofgem agree is a flawed approach given the circumstances. Risk levels alongside funding periods and other aspects of scheme valuation and funding must be considered holistically and the overall strategy should not be disaggregated for assessment or evaluation.

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

We do not believe Ofgem should adopt a prescriptive policy for de-risking unless it is focused on the behaviour and actions it expects NWOs to take and not pre-empt the outcome of a change in investment strategy for a particular scheme. We support the view that Ofgem should avoid judging the outcomes of de-risking with the benefit of hindsight. How de-risking strategies are constructed is a highly complex matter that is kept constantly under review in relation to the scheme assets and liabilities. As long as NWOs behave and act in a way whereby the strategies are considered constructively and justified with consideration of costs for consumers then Ofgem should not seek to 'compensate' consumers with penalties on NWOs.





We have a Group Finance Director sponsored Pension Scheme Committee whose remit is to test the ongoing efficiency of how we manage the schemes. This effectively helps us strike the balance of meeting customer, shareholder and Trustees (employee and members) interests and our obligations.

We understand that Ofgem have an expectation that de-risking should be dynamic, whereby taking advantage of attractive pricing or timing rather than applying a mechanistic approach to de-risking. We agree there should be an emphasis on a de-risking plan that considers the interests of consumers but that consumers would be particularly concerned about price volatility and high prices with a balance required.

We would be concerned about the application of hindsight bias when investment decisions are considered sub-optimal in comparison to what had an alternative investment decision been adopted. We would request that Ofgem clarify how they will determine appropriate de-risking strategies and clarity on how they would expect pension schemes and NWOs to engage with consumers.

## **Section 5 – Stranded / trapped surpluses**

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

In our view stranded surplus is unlikely in the current economic environment. If markets and interest rates/yields on bonds improve, our established de-risking triggers that are in place seek to lock in improved funding thus reducing risk of trapped surplus i.e. we will reach fully funded position with appropriate hedges in place and reduce future funding requirements.

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

Ofgem's stated commitment to only assess the actions of NWOs and not the outcome of decisions or with the benefit of hindsight is highly pertinent to any measure established to address a stranded surplus. If NWOs have made decisions which were reasonable at that time but still resulted in a stranded surplus we do not believe it would be equitable to levy a penalty on NWOs. In the end, today's surplus may become tomorrow's deficit with the converse true also.

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

We do not believe a formal policy should be prescriptive and should be based wholly on the actions and behaviour of NWOs and not the outcome of decisions. Involvement in assessing outcomes would result in benchmarking outcomes based on the benefit of hindsight which would be unfair.

We agree that Ofgem review each proposal on a case by case basis in advance of the decision as opposed to with hindsight but they should avoid 'approving' arrangements. Ofgem should acknowledge that the company has undertaken a reasonable level of diligence in the interest of consumers when reaching their decision.

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

Ofgem should support actions by NWOs to engage in alternative funding arrangements and consider cases for additional efficiently incurred costs for research and analysis of alternative funding proposals. This engagement is both expensive and complex requiring a significant degree of consideration on the net benefits to members, the company and to consumers. We do not believe a penalty enforced framework would be beneficial or appropriate to stimulate alternative funding proposals by way of unintentionally encouraging inefficient behaviour by NWOs. We would welcome ongoing engagement and dialogue with Ofgem regarding developments in this regard.

## **Section 6 – Trustee role and the Pensions Regulator's expectations**

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

We believe Ofgem have presented the role of trustees' accurately in the consultation document. Collective discussions with Ofgem and the PR would facilitate the development of more effective guide for trustees when considering consumers in their discussions with NWOs and ultimately their decisions.

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

There can be a tension between each regulator's objectives however the recent guidance from the PR does state that trustees need to consider impact of funding proposals on the sustainability of the business and consumers. We believe we have the adequate structures and robust dialogue to facilitate scheme valuations and recovery plans that reflect a fair balance between pension scheme members and consumers. We believe the PR must be involved during the development of Ofgem's policy.

## **Section 7 – Regulatory corporate governance**

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

Practical application guidance is required regarding the principles of Regulatory Business Governance in general and on pensions. We would encourage a robust and comprehensive dialogue of the obligations and requirements expected under these principles and how these will be reported and monitored by Ofgem, to ensure they add value to relevant stakeholders.

*Question 2: Do you believe this level of accountability will be effective in influencing NWO's behaviour?*

We believe there is already effective accountability on NWOs to fully engage in constructive and robust valuations and deficit funding periods on behalf of shareholders and consumers. For example, we engage fully in rates revaluations which are treated similarly to regulatory funding for pensions. We also believe, that if Ofgem develop the framework set out in this consultation in line with the comments made in this response, it should continue to reinforce this accountability.