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Dear Eliza

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

National Grid owns and operates the electricity transmission system in England and Wales. National Grid also owns and operates the gas transmission system throughout Great Britain and through our gas distribution businesses, we distribute gas to approximately 11 million offices, schools and homes.

We recognise the value of the certainty provided by Ofgem's Pensions Principles, which include the commitment to continue to fund efficiently incurred deficit costs associated with pre RIIO service, consequently we are supportive that this consultation doesn't look to review that commitment. However, we are also aware that further clarity in the interpretation of these Principles would be beneficial to Networks in order to facilitate the efficient management of pension liabilities in an evolving environment.

Our response to the consultation is in two parts: an executive summary of our key comments followed by a more comprehensive response by section on the issues raised in and by the consultation. These two sections should be considered together.

Executive Summary

We support the principles of clarity around the commitment to fund established deficits, and around transparency and accountability in scheme management and governance. We are also supportive of the impact on consumers being specifically considered at each stage of the input that the company has into the evolution of scheme's investment strategy and de-risking activities.

Funding Periods

We welcome Ofgem's thinking on providing clarity that allowances for deficit funding will continue beyond the initial 15 year period. We believe it is important that this flexibility is introduced without the certainty provided by the current 15 year period being undermined. This is important from a consumer and shareholder perspective to ensure that Networks' ability to negotiate an appropriate recovery length is not undermined. If it remains unclear exactly what allowance recovery periods Ofgem intends to use when valuation discussions take place, then trustees are likely to argue in favour of shorter deficit recovery periods. This will increase the funding burden on consumers in the short term.

In outlining a revised approach to the duration of funding periods there are a number of key principles that we would welcome Ofgem confirming in order to ensure that Networks have clarity on allowance funding and can negotiate similar length recovery periods with trustees, where appropriate. These principles are outlined below:

i. The existing 15 year recovery period should only be reviewed if the annual deficit funding requirement increased. There would be no reset of funding periods where the funding level is on or ahead of track. This would maintain a level of allowances consistent with an unchanged level of deficit funding contributions paid to the scheme.

ii. Funding periods should only be increased to the extent that is necessary to ensure that allowances do not need to increase. This mechanism should not be used to reduce allowances from their current levels but should provide allowances consistent with an unreduced level of deficit contributions.

iii. The maximum funding period should be confirmed as 15 years. This will help to protect consumers against excessive margins of prudence being included into Technical Provisions funding assumptions.

iv. Where funding levels improve and deficits reduce, Ofgem should be willing to consider shorter funding periods for setting allowances consistent with current annual allowances.

Risk Management

Risk management has become an increasingly important issue for schemes in recent years and will continue to increase in importance as schemes mature further and funding levels improve. It has also become a significantly more complex area with new risk reduction strategies and products becoming available all the time.

National Grid is supportive of Ofgem developing a more sophisticated approach to evaluating investment strategies and risk management. We believe that any initiatives in this area should be considered from both a consumer and shareholder perspective as they ultimately bear the funding risk and will benefit most from any risk reduction activities.

As the scheme sponsor we believe it is appropriate that we fully consider the impact on consumers, and ensure that our input into the setting of investment strategy and the introduction of risk reduction activities fully reflects the consumer's appetite for risk and return. However, we need to think carefully about how we feed in the consumer's views into the development of investment strategy as increasingly the strategies and products being considered are complex and require both specialist pension investment knowledge and scheme specific contextual knowledge to determine the best approach.

Stranded Surpluses

We view stranded surpluses as surpluses that arise after a scheme is fully funded on a self-sufficiency basis. Up to that point the scheme maintains a significant reliance on its sponsor and ultimately on consumers and shareholders. Well governed schemes should be managed such that the risk on consumers that further funding would be required would be reduced as the scheme moves toward full funding on a self-sufficiency basis.

Hence we believe that the opportunity for stranded surpluses in this environment is minimal as the risk and available reward in the scheme as it nears full funding on a self-sufficiency basis would be low and reducing. Moreover, any surplus above self-sufficiency at that point would likely have resulted from favourable investment and benefit experience, which we would expect consumers, shareholders and sponsors to welcome.

We recognise that many of the issues raised in this consultation are complex and evolving. We would like to be actively involved in future discussions with Ofgem in developing agreed approaches to these issues.

If you require any further information, or if you have any questions regarding our response, please contact me directly on 01926 655585. This response is not confidential.

Yours sincerely

James Kerrane
Pension Finance Manager

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Appendix – Comments on specific points and questions raised in the consultation

1. Cost of Capital

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

We agree that, in principle, providing certainty is likely to be beneficial from a cost of capital perspective, relative to an increase in uncertainty. We welcome any explicit certainty that Ofgem can provide regarding the funding of NWOs' pension deficits, especially in regard to providing a non time bound commitment that consumers will continue to fund an appropriate share of the overall scheme deficits in accordance with the Pension Principles.

Given the commitment to funding the regulated fraction of scheme deficits made in Ofgem's Pension Principles in the past, the allowed cost of capital in RIIO Final Proposals has implicitly assumed a high degree of certainty that efficient regulated pension costs will continue to be funded by consumers. Confirmation that Ofgem intend to continue to adhere to this principle should mitigate the increase in cost of capital which the uncertainty created by a new consultation on Ofgem's pension funding policy could otherwise cause.

Even so, investor perceptions of risk could be increased by the greater uncertainty created by other aspects of the consultation, for example in relation to the lack of clarity over future funding periods and the comments made in relation to any future "stranded surpluses" that may arise.

2. Funding Period

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

We welcome Ofgem's aspiration to provide clarity and certainty regarding the funding of established deficits beyond the initial 15 year period.

We acknowledge the principle that, given the strength of the employer covenant for regulated activities, pension deficits arising might theoretically be spread over longer funding periods of up to 15 years, rather than arbitrarily fixing funding periods to one future date such as 2027 or 2028.

However, we don't believe it is appropriate to re-spread existing deficits over continually extended future funding periods and believe this would not be acceptable to either trustees or the Pensions Regulator (tPR).

If it remains unclear exactly what allowance recovery periods Ofgem intends to use when valuation discussions take place, then trustees are likely to argue in favour of shorter deficit recovery periods. This will increase the funding burden on consumers in the short term.

Where a reasonable agreement is reached with trustees to maintain an unchanged level of pension deficit contributions following an updated actuarial valuation, consistent allowances should continue to be provided.

Consumer interests are best served by providing up front certainty and clarity to Networks in regard to the period over which Ofgem will provide deficit allowance funding. In order to do that we believe that a revised approach should embrace the following four principles:

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i. Funding periods only extended when funding has worsened

The existing 15 year recovery period should only be reviewed if the annual deficit funding requirement increased. There would be no reset of funding periods where the funding level is on, or ahead of, track. This would maintain a level of allowances consistent with an unchanged level of deficit funding contributions paid to the scheme.

Example 1
Initial deficit of 150 funded over 15 years. (In the following examples the impact of discounting and investment returns is ignored.)

Original Deficit = 150															
Allowances	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10
Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15

At a later valuation a new deficit of 30 calculated 12 years after the initial deficit of 150 can be spread by maintaining the existing level of deficit allowances and existing funding period length.

New Deficit = 30															
Allowances	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10
Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15

A revised methodology should be clear that deficit funding allowances in such cases would be spread over the shorter period (in this case 3 years) rather than re-spreading over another 15 year period.

ii. Funding periods only increased marginally

Funding periods should only be increased to the extent that is necessary to ensure that allowances do not need to increase. This mechanism should not be used to reduce allowances from their current levels, but should provide allowances consistent with an unreduced level of deficit contributions where a reasonable funding agreement has been reached with trustees to maintain that existing level.

Example 2
Initial deficit of 150 funded over 15 years.

Original Deficit = 150															
Allowances	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10
Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15

At a later valuation a new deficit of 130 calculated 3 years after the initial deficit of 150 can be spread by maintaining the existing level of deficit allowances extended for one year. Total length of new deficit funding period is 13 years, not 15.

New Deficit = 130																
Allowances	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	**10**
Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	**16**

A revised methodology should be clear that deficit funding allowances in such cases would be spread over the shorter period (in this case 13 years) rather than re-spreading over another 15 year period.

iii. Maximum 15 years

The maximum funding period should be confirmed as 15 years. This will help to protect consumers against excessive margins of prudence being included into Technical Provisions funding assumptions.

Example 3

Initial deficit of 150 funded over 15 years.

Original Deficit = 150															
Allowances	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10
Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15

At a later valuation a new deficit of 180 calculated 3 years after the initial deficit of 150 can be spread by increasing the existing level of deficit allowances to 12 with a new deficit schedule of 15 years.

New Deficit = 180																		
Allowances	10	10	10	12	12	12	12	12	12	12	12	12	12	12	12	**12**	**12**	**12**
Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	**16**	**17**	**18**

A revised methodology should be clear that deficit funding allowances in such cases would be spread over a maximum of 15 years.

iv. Reduction in funding periods when funding improves.

Where funding levels improve and deficits reduce, Ofgem should be willing to consider shorter funding periods for setting allowances consistent with current annual allowances.

Example 4

Initial deficit of 150 funded over 15 years.

Original Deficit = 150															
Allowances	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10
Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15

At a later valuation a new deficit of 60 calculated 3 years after the initial deficit of 150 can be spread by maintaining the existing level of deficit allowances with a reduced funding period length of 6 years.

New Deficit = 60															
Allowances	10	10	10	**10**	**10**	**10**	**10**	**10**	**10**	-	-	-	-	-	-
Year	1	2	3	**4**	**5**	**6**	**7**	**8**	**9**	10	11	12	13	14	15

A revised methodology should be clear that deficit funding allowances in such cases would be spread over the shorter period (in this case 6 years) rather than re-spreading over the initial 15 year period.

Maintaining existing deficit allowances over a shorter period reduces the reliance on future consumers by reducing the length of time for which allowances are funded.

In advance of the next set of valuations, a clear set principles / guidelines regarding how allowances will be calculated in future would be valuable. This will provide greater certainty in relation to regulatory recovery and should augment Networks' ability to negotiate recovery plans with trustees that reflect the enhanced covenant that that certainty provides. Clearly it is in consumers' interest to facilitate this.

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

We welcome Ofgem's aspiration to provide clarity and certainty regarding the funding of established deficits beyond the initial 15 year period.

It is also imperative that any revision to the funding regime is absolutely clear in advance as a lack of certainty and clarity regarding the length of deficit allowance funding periods would undermine the ability of Networks to negotiate on consumers' behalf in funding discussions.

3. Future Focus

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

We are in favour of reviews that focus on areas within the influence of NWOs. We agree that while the reviews were initially a useful tool, a more nuanced approach would be more useful going forward. In particular we believe that the benchmarking of return seeking assets in the review would have become an increasingly misleading measure were it retained and this type of crude benchmarking doesn't incentivise the most efficient risk management approaches. Innovative and sophisticated investment strategies are not well evaluated by the current approach and a benchmarking approach in general in this area is likely to provide inappropriate incentives to Networks.

We also see limited benefit in focussing future reviews on benefits as we believe there are already effective incentives in the Totex mechanism to drive the right behaviour.

We welcome a focus on improving administrative efficiency and reducing costs in reasonable ways. But we believe that any easy wins alluded to in paragraph 3.15 of the consultation document are likely to be very small, if they exist at all, given the small proportion of pension costs taken up by administration costs, as already acknowledged in the consultation (paragraph 3.15).

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

We are very willing to consider liability management exercises which offer real benefits to members and consumers. But we believe that any liability management exercises (such as offering an option to pensioners for an immediate, one-off uplift in their payments in exchange for foregoing future inflation linked increases) needs to be very carefully thought through before taking it forward. The benefit of such exercises may be limited for some schemes and they may not be appropriate or efficient to undertake, given the cost and risks involved.

The costs of some liability management exercises with low member take-up could potentially exceed any consumer benefits.

While there may be a minority of members who might benefit from exercising such an option, the reluctance on the part of trustees and the high potential costs of communicating and making such an offer to members may outweigh any immediate reduction in risk or benefit cost.

The Pensions Regulator has issued clear guidance pointing out the potential risks, e.g. long-term legal and reputational, as well as potential high costs of incentive exercises.
(see http://www.thepensionsregulator.gov.uk/guidance/incentive-exercises.aspx)

National Grid has already been innovative in our approach to reducing the cost of defined benefit accrual for scheme members, including protected persons. We have achieved this by collective bargaining on employment terms and conditions.

As a result, in Ofgem's 2014 Reasonableness Review, National Grid was acknowledged to be reducing the risk of their pension schemes to unexpectedly high future pay awards[1]. The ability for networks to manage costs in this area is limited but should be considered.

We also make use of salary sacrifice to minimise the cost of ongoing pension provision as far as possible. And where the rules allow, e.g. in the NGEG of the ESPS (National Grid Electricity Pension Scheme), we have capped benefit in payment increases to a maximum of 5% in the past when RPI has exceeded 5% pa. However, we recognise (as does the consultation document) that differing scheme rules make this practically impossible for some other NWOs to achieve.

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?

We agree that setting risk levels is an area most appropriately considered by trustees and employer sponsors, and we welcome the aspiration not to judge de-risking outcomes with the benefit of hindsight. Any retrospective appraisal of investment strategies disincentivises innovative behaviour which is not in consumers' interests. This risk can be further reduced by Ofgem clarifying this commitment thus: **Ofgem will not judge the outcomes of de-risking or investment strategy decisions with the benefits of hindsight.**

Whilst each Network as a scheme sponsor should carefully consider the impact on consumers of the risk level within their scheme, it is generally the trustees that set investment strategy and determine the appropriate approach for each specific scheme. We would expect that Networks in consultation with trustees would highlight the perspective that consumers are likely to have in relation to risk and reward.

However, we have some reservations about the practicalities of providing a coherent and robust consumer interest case using the resources listed in Section 4.3 of the consultation document. Consumers are in a similar position to shareholders in this regard as they ultimately bear the costs and rewards of risk reduction, however we believe it would not be best practice to adopt an approach to understanding shareholder risk as outlined in Section 4.3.

Moreover, neither shareholders nor consumers are a homogenous group and it is unreasonable to expect them to have a consistent and sufficiently developed understanding of the complexity of risks associated with a specific pension scheme's funding.

We believe it is appropriate that Networks seek to understand the consumer viewpoint on funding and risk management at a high level prior to trustee consultation on investment strategy. However, we believe that the detail of how risk is managed, for example which pension risks are prioritised should be set by trustees in consultation with the scheme sponsors and after taking appropriate specialist investment and actuarial advice.

In terms of understanding the high level consumer perspective on risk and reward we believe that organisations with a track record of understanding pension funding requirements might be best placed to provide that input.

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[1] Paragraph 3.23 of Review of Network Operators Pension Costs for Ofgem by Government Actuary's Department, 27 November 2014

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

In section 4.6 of the consultation it is inferred that a reduction in 'return seeking assets' in the 2014 reasonableness review demonstrates a move toward de-risking. We should be careful in making such high level assumptions since the measures used in the review were crude and some schemes may for example reduce the level of assets traditionally categorised as 'return seeking' and replace with a higher proportion of higher yielding bonds without reducing the level of overall return or risk in the scheme.

5. Stranded / Trapped Surpluses

Our response below covers all of questions 1 to 4.

We acknowledge Ofgem's aim to avoid consumers paying too much, too early in respect of established deficits. However, we do not believe that a surplus should be measured against the Technical Provisions (TP) valuation of the liabilities, but rather against the trustees' aim to achieve a fully-funded position on a self-sufficiency basis[2].

For schemes that are relatively close to full funding on a technical provisions basis, it is in consumers' interest that risk and volatility of funding be reduced. Consequently, we would expect that schemes should be targeting full funding on a self-sufficiency basis, and it is prudent, efficient and necessary that in order to do that they will need to be in a surplus on the current TP basis at some point in time. Avoiding a TP surplus therefore is not an option for a well-run scheme and furthermore would not be in consumers' interests.

Trustees are unlikely to consider any refund of surplus to the employer unless the scheme was at least fully funded on a self-sufficiency basis, so there is no risk of the employer receiving a refund at the expense of consumers.

Surpluses arising from judicious investment strategies and well-chosen asset portfolios should be encouraged and welcomed up to the point of self-sufficiency. Discouraging investment surpluses arising from investment outperformance would be inefficient and ultimately costly to consumers.

National Grid has already secured agreement to alternative funding arrangements like escrow security accounts and letters of credit. We believe there should be full recovery for the reasonable cost of alternative funding arrangements, which help to limit the level of deficit funding contributions required to be paid to the scheme. We would welcome a framework that is capable of assessing all reasonable alternative funding proposals, and quickly provides a decision to approve them or not.

6. Trustee Role and The Pensions Regulator (tPR)

Our response below covers both questions 1 and 2.

We welcome an approach that would see all negotiating parties at pension discussions (trustees and Networks) giving due consideration to the interests of shareholders, consumers, employees and members.

We are in favour of Ofgem and tPR working together to provide clear and consistent guidance on giving due weight to all stakeholders' interests, especially when setting deficit recovery plans. Greater alignment of the two regulators' approaches should make reaching agreement on scheme valuations and recovery plans a smoother process.

[2] 49% of UK respondents to Aon Hewitt's 2015 Global Pension Risk Survey indicated that their scheme is targeting self-sufficiency as their long-term objective, with a further 27% targeting full buyout funding in the long term.

However, trustees are legally bound under trust law to consider the interest of scheme members and beneficiaries. They are not as strongly bound to follow guidance on considering the interests of other stakeholders to the same extent as members and beneficiaries. Some trustees may therefore feel less of an obligation to consider the interests of consumers or shareholders other than in regard to how it may impact on covenant.

7. Regulatory Corporate Governance

Our response below covers both questions 1 and 2.

National Grid has rigorous pension governance frameworks in place that succeed in recognising and seeking to protect the joint interests of both consumers and shareholders.

Among others things, this involves careful and rigorous analysis and testing of scheme valuation inputs, e.g. data, assumptions and actuarial methods, by both informed investment committee members and professional external advisers. We would welcome the opportunity to report on the extent of our existing pension scheme governance processes which we anticipate will provide a high level of comfort and assurance to both Ofgem and consumers.

We would prefer any regulatory governance requirements to be as flexible as possible, providing appropriate flexibility to Networks to evidence their governance processes and would expect that any requirement would be limited to information that is available to the sponsor, as opposed to held by the trustees.

We agree with the proposal to leave it to tPR to guide trustees as to how they might take NWOs' consumer advocacy into account (para 7.8). But we believe it is important that Ofgem acknowledge that the implication of this is that Networks cannot reasonably be held accountable for this guidance or how trustees (who are subject to their own legal obligations and are accountable to their own regulator) have applied it.

The GAD Review of NWOs' pension costs states that investment allocations, funding methodologies and assumptions are broadly consistent with other typical UK private sector DB pension schemes. We believe this illustrates how all NWO schemes (not just those with significant non-regulated elements) are already very well incentivised to consider the consumer interest case. We believe therefore that the outcome of a requirement on NWOs to report to stakeholders on their pension scheme governance is more likely to be an increase in transparency, rather than an explicit influence on NWOs' behaviour. Consequently, we believe that increased transparency should be the main aim of any such proposed reporting requirement.