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Mr I Rowson
Ofgem
9 Millbank
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Dear Ian

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

Thanks for your communication in relation to the above. We have set out below our overall response to the above consultation.

Given Ofgem's current funding approach, in order to provide protection against adverse cost of capital movements and ensure NWOs take appropriate action to proactively manage costs and risks on behalf customers, we believe Ofgem should focus on the following when finalising their approach:

- Ofgem should ensure that it is clear that the customer will bear all pension costs and risks associated with the established deficit. This protects the cost of capital and creates an improved environment within which to take an efficient approach to managing costs and risks, as it provides clarity on the strength of the covenant which trustees require in order to enable a wider range of possible solutions.

- Ofgem should consider introducing a new incentive mechanism which rewards NWOs who take action to manage costs and risks (and penalises NWOs who do not take action) on behalf of customers.

Our view is that the incentive mechanism is a key component, as the management of pension costs and risks in the sector is more complicated than in other sectors. This complexity results in a much greater downside risk on NWOs who attempt to take action and "break new ground", in the form of industrial action and deterioration in the general employee relations environment which has implications for operational performance and so influences other incentive mechanisms.

Given this, any new incentive regime must be meaningful, transparent and robust and should reward NWOs who "break new ground" on managing pension costs and risks on behalf of customers and compensate them for the downside risk if unsuccessful.

Answers to the specific questions posed in the consultation are detailed in the attached Appendix.

Yours sincerely

Gareth Jones
Pensions Manager

Appendix

Section 1

1. Do you believe our proposals will provide protection against adverse cost of capital movements?

   Clarity over the commitment to fund the established deficit beyond the original 15 year period is positive although increased uncertainty over the length of future recovery periods and the amount of funding NWOs will receive could be perceived negatively.

   Given this, in order to ensure there are no adverse cost of capital movements we believe Ofgem should ensure it is clear that the customer will bear all pension costs and risks associated with the established deficit.

Section 2

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

   We believe the policy of spreading any new[1] deficits over a longer recovery period is broadly sensible when coupled with the increased commitment to fund deficits beyond the original 15 year period.

   However, trustees may not always be comfortable adopting this approach when agreeing a contribution structure with NWOs given the wording included in the Pensions Regulator's code of practice in relation to regulated utilities, which effectively states that regulated allowances are only one factor that trustees should consider. As a result, we believe further work is required to ensure that the Pensions Regulator and trustees are comfortable with Ofgem's proposed approach.

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

   Given Ofgem's proposed change to how it will fund the established deficit in the future, we believe further clarity over how it will determine future allowances would assist NWOs to agree long term funding and investment plans which are acceptable to all parties.

Section 3

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

   We agree that it is sensible to focus on areas which are within the influence of NWOs and are of value to customers.

   However, it should be noted that using the wider private sector for benchmarking purposes in this area may not be appropriate given that non-regulated private sector companies generally have more flexibility to make changes to benefit and contribution levels as they do not have the additional restrictions of the various pension protections that were put into place in the gas and electricity industries at privatisation. In addition, administration costs do not typically represent a significant proportion of a scheme's costs, are not entirely within an NWOs control and a mechanism for reviewing and

[1] We have assumed that Ofgem regard "new" deficits at future valuations to be any deficit which exceeds the present value of the remaining payments under the current Schedule of Contributions.

resetting these costs has already been agreed as part of RIIO-GD1. As a result, we do not believe they should form part of the review.

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

   We believe the reasonableness review should also focus on other areas within the influence of NWOs which could add value to customers (e.g. the use alternative funding arrangements which could allow the trustees and company to agree longer recovery periods / pay lower cash contributions).

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

   Please see our overall response.

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

   There is scope to change benefits and engage in constructive liability management although it should be noted that, given the legal protections which exist for accrued pension benefits and the additional restrictions of the various pension protections that were put into place in the gas and electricity industries at privatisation, the impact of such exercises will typically be greater on future benefits than on historical benefits which determine the size of the established deficit.

   As a result, we believe Ofgem should consider the overall impact of any actions taken by NWOs and should not simply look at the impact on the established deficit in isolation.

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

   We believe the introduction of a carefully considered incentive mechanism should provide enough encouragement to NWOs.

Section 4

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

   We understand that Ofgem's concern in relation to risk levels stem from a desire, given the covenant strength provided by the regulatory regime, for customers not pay for the increased costs associated with overly aggressive de-risking strategies.

   Given this and the fact that that this question is extremely difficult to answer in practice, we believe the easiest approach to ensure risk levels represent the best interest of customers is to agree an appropriate incentive mechanism.

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

   We are in agreement with Ofgem's comments in relation to de-risking. In particular, we agree that de-risking should not be purely mechanistic and that de-risking strategies should have consideration for the scheme's funding level, other market indicators and risk tolerances in the business and should be reviewed regularly and following any significant changes to the scheme or economic environment.

However, we do not believe a more prescriptive policy would add any value as, in practice, it would be extremely difficult to implement.

Section 5

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

   Ofgem have defined a stranded surplus as being "a surplus in relation to the established portion of the deficit which could not be returned to customers".

   Based on this definition, we believe the likelihood of a stranded surplus occurring is low as any identified surplus would typically be used to;

   - reduce the scheme's overall risk profile and therefore no surplus would exist; or
   - reduce or cease deficit payments to the scheme which would lead to a reduction in the amounts paid by customers via the reset or true-up mechanisms.

   Further, we believe that the introduction of an appropriate incentive mechanism for the established deficit will encourage effective management of all risks in the pension scheme – including the risk of a surplus emerging.

   Finally, the rules of our pension scheme mean that once all benefits have been paid any remaining surplus would be refunded to the company of which an appropriate proportion could be returned to customers.

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

   Please see the answer to question 1 above.

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

   Please see the answer to question 4 below.

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

   No. Further clarity, in the form of a guidance document, setting out how Ofgem would treat different types of alternative funding arrangements (e.g. the treatment of implementation costs, ongoing costs, the impact on deficit funding and true ups) would be beneficial.

Section 6

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

   We believe this section broadly describes the role of the trustees' in relation to this framework. However, in addition to the extracts from the Pensions Regulator's latest code of practice included in this section, it should be noted that the code of practice also states that regulated allowances are only one factor that trustees of regulated utility pension schemes should consider.

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

   In our view, the proposed approach set out by Ofgem is not sufficiently consistent with the Pensions Regulator's latest code of practice. As a result, it would be helpful if the Pensions Regulator could clarify its position in relation to employers subject to price regulation in order to enable NWOs and trustees to agree scheme valuations and recovery plans which are acceptable to all parties.

Section 7

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

   Please see our answer to question 2 below.

2. Do you believe this level of accountability will be effective in influencing NWOs behaviour?

   In our view, including the proposed statement in relation to pensions governance will not significantly influence an NWOs behaviour.

   We believe the introduction of an appropriate incentive mechanism and / or the proposed change to the focus of the reasonableness review will have a much bigger impact on NWOs behaviour. As a result, if the reasonableness review is to be retained, we would suggest that a statement along the lines indicated by Ofgem should be included as part of the triennial submission for each reasonableness review rather than as part of the Statement of Regulatory Governance.