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Second Consultation on Ofgem's Policy for Funding Network Operators' Pension Scheme Established Deficits

Introduction

This report sets out Aon Hewitt's response to the Second Consultation on Ofgem's Policy for Funding Network Operators' Pension Scheme Established Deficits published on 16 March 2016.

Aon Hewitt are actuarial advisers to a significant proportion of network operators and trustees in the regulated electricity industry, resulting from a close and long-term association with the Electricity Supply Pension Scheme (ESPS). However, we are responding to Ofgem's consultation solely as a pensions practitioner and not on behalf of any specific regulated network operator, set of pension scheme trustees or representative body (such as the Electricity Networks Association (ENA)).

Ofgem's consultation does not ask specific questions, but rather seeks any further comments based upon their detailed proposals in their consultation document. We have set out our comments on Ofgem's consultation document below.

General Comments

We believe Ofgem have generally done well in addressing concerns that Ofgem's policy for funding Established Deficits was sacrificing certainty in favour of flexibility – Ofgem’s position and proposed changes in methodology have largely been clarified in this consultation document.

We also welcome Ofgem’s move away from benchmarking and penalties for outliers, and the focus now on how well a NWO’s engagement in pension scheme governance serves the consumer interest.

We believe there are some aspects of Ofgem's policy and detailed proposals that warrant further clarification by Ofgem. These are discussed in the sections that follow, using the headings from Section 2 of Ofgem's consultation document. In addition, we have expanded on the following topics which cut across a number of the headings Ofgem use:

- Evidence of Representing Consumer Interests
- Major Initiatives
- Alternative Funding Arrangements

Our final section contains some technical feedback on the proposed methodology.

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Funding Period

We welcome the reassurance that Ofgem provide in relation to the enduring commitment to the funding of Established Deficits even beyond the end of the existing period of 15 years starting at the Cut-Off Date. We believe that both trustees and NWOs will welcome the fact that this is not a rolling 15-year period. We believe this is consistent with the Pensions Regulator's (TPR) desire that recovery plans should not be re-spread unless there is an appropriate change to employer covenant or investment strategy to support this.

We recognise the need to spread any new deficit found at a valuation but do not necessarily expect that trustees will be comfortable with a 15-year period, depending on their assessment of the employer covenant.

Where a pension scheme is ahead of plan we expect that trustees and NWOs may have differing views as to whether this should lead to a shorter period to reach full-funding, the ability to de-risk sooner or a reduction in deficit contributions. We believe it is reasonable for the NWOs to take into account their responsibility to consumers when they are negotiating with their trustees.

Future Focus

Ofgem's consultation document implies that incremental deficits, future service benefit costs, administration expenses and PPF levies fall outside of future Reasonableness Reviews, but this is not explicitly stated.

It would be helpful to NWOs if Ofgem confirmed this.

Scheme Approach to Risk

We welcome flexibility provided by Ofgem's views on their approach to scheme risk and de-risking. We agree that a more prescriptive approach is not required. Ofgem acknowledge this is a complex area and in practice we are not clear whether academics and consumer representatives will be well-placed to comment on the level of risk that consumers should support in guiding the NWOs in how to negotiate with their trustees.

Surpluses

We remain of the view that trustees are unlikely to see surplus as “stranded” unless the pension scheme has a surplus when measured against a level higher than technical provisions i.e. buy-out or, possibly, self-sufficiency.

While NWOs can seek to influence trustee behaviour, it is the trustees that control investment strategy. In practice a NWO might have limited ability to control whether surplus above technical provisions is used to reduce contributions, reduce risk or accelerate the trustees’ progression towards buy-out or self-sufficiency.

We believe that Ofgem should recognise this by not penalising NWOs whose trustees use surplus above technical provisions to protect members' benefits.

Trustee Role & TPR's Expectations

Ofgem assert that TPR expects trustees to recognise that a NWO’s considerations for risk tolerance, risk-taking and long-term aims reflect its duty to consider consumer needs.

We agree that trustees are likely to acknowledge that Ofgem expect the NWO to represent consumer interests when engaging with their trustees.

However, we have not seen any guidance from TPR on how trustees should recognise this expectation in reaching agreement with the NWO on the technical provisions and the recovery plan. Without any further guidance from TPR, we are not convinced that trustees will recognise that this expectation on the NWO to protect consumers overrides their responsibility to protect pension scheme members.

We understand that in discussions between Ofgem, the ENA and TPR in August 2015, TPR expressed a view that it can be "covenant-enhancing" for a NWO to agree a recovery plan which limits the cost impact on consumers.

We believe it would be helpful to NWOs and their trustees if TPR confirmed that this view would not be out of line with UK funding regulations or TPR's funding code of practice.

We believe that Ofgem are best-placed to ask TPR for this confirmation.

Regulatory corporate governance

We look forward to further Ofgem guidance on how NWOs should report on pension scheme governance in their Statements of Regulatory Corporate Governance within RIIO Accounts.

We wish to take this opportunity to remind Ofgem that trustees control much of the information in relation to the pension scheme and, particularly if they feel it would adversely impact on their negotiating position, may not always be willing to release information to the NWO.

Evidence of Representing Consumer Interests

Ofgem propose to ask NWOs to submit explanations and supporting evidence for their representation of consumer interests in setting investment and risk strategies, engagement with trustees and responses to previous Reasonableness Reviews.

By way of an example, NWOs would be able to propose a profile of Established Deficit allowances, giving scope for this profile to mirror the recovery plan agreed with their trustees. In framing their proposals, NWOs would need to set out why they consider their proposals appropriately protect the interests of consumers. (We note that Ofgem's requirement that a NWO's proposed profile of allowances serves the consumer interest seems to be at odds with the lack of obligation on the trustees to serve the consumer interest.)

Whilst we do not believe that Ofgem need to be prescriptive regarding the evidence that NWOs should submit, we do believe it would helpful if Ofgem suggested examples of what would be deemed to be reasonable evidence that a NWO has adequately represented consumer interests.

Major Initiatives

We welcome Ofgem's proposal to allow consumer funding (albeit on an exceptional basis) for advisory costs relating to "major initiatives" capable of generating material benefits for consumers. The introduction of this pass-through mechanism via the payment history allowances removes an economic disincentive for NWOs to engage in these initiatives.

Whilst Ofgem's proposals refer to benefit management and alternative funding arrangements in this context, there are other initiatives that carry a reasonable expectation of generating benefits for consumers, such as longevity risk management.

We believe it would be helpful for Ofgem to confirm that a "major initiative" is <u>any</u> initiative that carries a reasonable expectation of generating benefits for consumers through better management of the costs of funding the Established Deficit. We also believe it would be reasonable to include the costs of feasibility studies in the costs that are passed-through to consumers, as disallowing these costs seems to unnecessarily discourage NWOs from fully considering these opportunities.

In response to Ofgem's offer of further support, we believe there is merit in Ofgem providing central support to addressing industry-wide uncertainties that might prevent NWOs from considering some opportunities further.

By way of example, before undertaking significant work in considering a benefit management initiative, many of the NWOs and their trustees would need legal confirmation that this initiative does not breach the Protected Person Regulations or the "No Detriment" provisions in pension scheme rules. Given this is largely an industry-wide uncertainty, it would be helpful for Ofgem to clarify how they expect this uncertainty to be addressed – it may be helpful for Ofgem to either seek Counsel's opinion on behalf of these NWOs or otherwise confirm that the associated costs would be funded by consumers.

Alternative Funding Arrangements

We welcome Ofgem's suggestion that an alternative funding arrangement could enable trustees to agree a longer recovery plan and/or lower annual deficit repair contributions.

Ofgem's default position seems to be that consumers would not fund any payments made by the NWO to this arrangement, but would provide funding if a payment is subsequently made from this arrangement to the pension scheme. This is not necessarily in shareholder interests, as the capital needed could be tied up in this alternative funding arrangement for a significant period before this is either paid to the pension scheme or returned to the NWO.

We believe it would provide stronger encouragement to use alternative funding arrangements if Ofgem clarified that a NWO's proposed profile of Established Deficit allowances can reflect payments made to the pension scheme and payments made to an alternative funding arrangement, when it is in consumers' interests to avoid over-funding.

It would also be helpful to clarify that pass-through extends to costs associated with other forms of security, such as premiums for surety bonds and bank charges for letters of credit.

Technical Feedback on Proposed Methodology

We have some technical feedback with Ofgem's proposed methodology:

- Ofgem have proposed changes to the Financial Handbook in Appendix 2 of the consultation document, using RIIO-ED1 to give these proposals context.

  The proposed changes shown in this context would need appropriate modification to apply to RIIO-T1 and RIIO-GD1.

- Ofgem's proposed revision to the Pensions Deficit Allocation Methodology in paragraphs 3.36 and 3.37 refers to the "value of future benefit accrual".

  We believe this should refer to the "employer's share of the value of future benefit accrual", as this needs to allow for deduction of members' contributions paid (including payments under salary sacrifice).

- The calculation of the indicative further PSED repair period (rpa) in paragraph 3.28 of Appendix 2 includes an adjustment to round this up to a whole number of years.

  We believe it would be helpful for Ofgem to clarify why this rounding up has been proposed.

- The calculation of the Indicative Base Annual PSED Allowance (IBAPA) in paragraph 3.30 of Appendix 2 makes no allowance for the difference between the IBAPA and the Base Annual PSED Allowance actually received by the NWO in the two Regulatory Years following the pension scheme valuation date.

  If Ofgem decided that a NWO's allowances would be set with reference to the IBAPA, rather than the Proposed Base Annual PSED Allowance (PBAPA) set by the NWO in accordance with paragraphs 3.32 and 3.33 of Appendix 2, we believe an adjustment to IBAPA is likely to be necessary.

  We believe it would be helpful for Ofgem to clarify how IBAPA would be adjusted to reflect the Base Annual PSED Allowance actually received by the NWO in the two Regulatory Years following the pension scheme valuation date.

- The calculation of the cumulative payment history variance value in paragraph 3.37 of Appendix 2 includes a deduction to D_y for the amount by which ongoing pension contributions have been reduced on account of a PSED surplus.

  We believe that paragraph 3.38 of Appendix 2 requires further clarification, as the proposed wording does not clearly explain how Totex should be adjusted (if at all) for the amount by which ongoing pension contributions have been reduced on account of a PSED surplus.

  We believe that a numerical example would be helpful.

- The calculation of the cumulative payment history variance value in paragraph 3.37 of Appendix 2 includes an addition to D_y for the amounts received, or forecast to be received, by the pension scheme in respect of PSED repair.

  We believe it would be helpful if Ofgem clarified that D_y would include an addition for amounts paid to an alternative funding arrangement and amounts paid to establish other forms of security (assuming Ofgem have agreed that these amounts will be passed-through).

- In the calculation of the cumulative payment history variance value in paragraph 3.37 of Appendix 2, E_y is the sum of the licensee's Base Annual PSED Allowance and the licensees' payment history allowance.

  We presume that the Base Annual PSED Allowance included in E_y is the Base Annual PSED Allowance actually received by the NWO, rather than the IBAPA derived according to paragraph 3.30 of Appendix 2. We believe it would be helpful if Ofgem clarified this.

- The calculation of the cumulative payment history variance value in paragraph 3.37 of Appendix 2 includes the 2015/16 net present value of the true-up cash adjustment for 2009/10 calculated for the RIIO-ED1 final determinations (DP5TUV).

  We believe it would be helpful if Ofgem clarified how NWOs should determine this value (unless Ofgem have already confirmed, or will confirm, the value of DP5TUV to each NWO).

- The calculations in paragraph 3.33, 3.37 and 3.39 of Appendix 2 refer to a multiplier (f in 3.33 and f_y in 3.37 and 3.39) to be substituted into the formula. We understand that these multipliers are intended to adjust for the timing of payments during the year (i.e. being paid evenly throughout the year rather than being paid as a lump sum at the end of the year).

  However, we understand that some readers of Ofgem's consultation document have found references to f and f_y confusing.

  We believe the same calculations could be specified more clearly by allowing for the timing of payments directly within the formulae.
