



Ofgem's policy for funding Network Operators' Pension Scheme Established Deficits

Northern Powergrid's response to Ofgem's policy for funding Network Operators' Pension Scheme Established Deficits

KEY POINTS

- **We are pleased that Ofgem has consulted further on these important proposals, recognising the significant concerns raised during the first consultation. We support Ofgem's aims in this reform: a commitment to consumer funding of established deficits and a move away from an examination of outliers in specific assumptions to a new approach based on participation in scheme governance.**
- We are pleased to see the primacy of the statutory role of pension scheme trustees in the management of pension schemes recognised in this consultation.
- The Pensions Regulator's letter to the ENA indicates that the aims of the two regulators can be compatible but there remains a clear risk that the respective positions on deficit repair periods may diverge.
- The further detail on the basis of calculating revised Ofgem funding arrangements is welcomed, as is the clarity that Ofgem's commitment to fund the established deficit is an enduring one and will remain in place following any periods of surplus.
- We agree that the focus of future reasonableness reviews should be on areas which impact on the value of the commitment shouldered by customers, such as liability and benefit management initiatives, rather than benchmarking actuarial assumptions. Ofgem's potential funding support for these initiatives is also welcomed.
- We do not agree that penalties should be applied to NWOs for failing to take up liability management initiatives which can only be implemented by trustees.
- We support Ofgem's non-prescriptive approach towards risk management and its recognition that trustees, in consultation with the Company, are best placed to manage risks.
- Whilst it may be inappropriate to assume de-risking is *necessarily* in the interest of consumers, we believe that there are circumstances where de-risking to remove volatility as the schemes mature will deliver long-term value for consumers. It is also important to remember that risk decisions are ultimately taken by trustees in the members' interests and that as consultees we will continue to advocate the interest of customers and shareholders.
- We agree that a true stranded surplus is unlikely but we require clarity on how this will be defined. Ultimately, we recognise that consumers stand behind the deficit and they should be protected (or benefit in some manner) from any over-funding to which they have contributed.

1. Introduction

1. In general we support the Ofgem's aims of this reform and our key comments are described above. In the following sections we expand on these comments using the headings from Section 2 and 3 of the consultation document. We then provide more detailed comments on the appendices.

2. Reason for change and funding period

2. We concur with Ofgem that clarifying its commitment to the funding of established deficits would help to protect the interests of both existing and future customers.
3. Ofgem's confirmation that the commitment is an enduring one, and that the commitment remains even after an interim period of surplus position is a positive step and, together with the further detail of how this commitment will be implemented, is welcomed.
4. The letter to the ENA from the Pensions Regulator provides some assurance that taking customers' interests into account does not preclude trustees acting in members' best interests. However, we would caution that the Pensions Regulator has not committed to a stance where trustees must take into account customer interest and we must still recognise that under law trustees have absolute responsibility for the management of the schemes and their primary duties are to their members.
5. The trustees will continue to be guided by the Pensions Regulator and, whilst a view has been expressed to the ENA, it is important that there is consistency between the two regulators in the approach to this issue. To achieve this consistency, sector specific joint guidance issued by both Ofgem and the Pensions Regulator should be the aim.
6. We note Ofgem's stance that it does not agree that a strong covenant should lead to a shorter recovery period, as it believes the covenant derives from the ability to raise revenues from current and future consumers. Whilst we agree this should give confidence and clarity to trustees to consider longer recovery periods the statement from the Pensions Regulator falls short of endorsing this approach. We agree that the aims of the two regulators are not incompatible in the current circumstances, but there remains some uncertainty that this will always be the case. For example, if a large deficit arises towards the end of the initial 15 year period Ofgem's proposals would lead to a further significant lengthening of the deficit repair period. The problem is that such a lengthening may not be acceptable to trustees unless the

Pensions Regulator is prepared to give trustees guidance that will allow them to be satisfied that an extension to the recovery period is consistent with their duties in the special circumstances that prevail in the case of regulated networks whose covenants are backed by a solemn commitment from a regulator. Without such clarity from the Pensions Regulator, the approaches of the two regulators may still appear to be incompatible to the trustees. In those circumstances it will be difficult to persuade trustees to give primacy to the view of the economic regulator, when the regulatory body to which they are accountable is unwilling to bless the approach with sector-specific guidance that would permit the trustees to depart from the Pensions Regulator's generic guidance about recovery periods and covenant strength.

7. We note the Pension Regulator's guidance¹ that trustees should not only assess the current covenant but also the ability of the Company to meet medium and long term commitments. We will urge the trustees to take this guidance into account and to agree longer term funding, if necessary; the customers' interests are aligned with the Company's interest in this respect.
8. We agree with Ofgem that there is no explicit evidence that the NWOs' schemes have produced an overly prudent view of technical assumptions and deficit recovery plans and welcome that Ofgem believes its current proposals further mitigate against this.
9. We also welcome the clarity set out in the consultation document on the possible extension or shortening of the recovery period. However, we would reiterate that trustees are the key decision makers in any funding agreement and, whilst we can assiduously promote consumer interests, the trustees will have an overriding obligation to secure the interests of their members. Where the immediate interests of consumers diverge from scheme members' interests, as understood by trustees, neither NWOs nor Ofgem can change trustees' duties and they must give precedence to their members' interests.

3. Future focus

10. We agree with Ofgem that the reasonableness reviews should move away from benchmarking actuarial assumptions; we believe the focus should be on those areas within the influence of the NWO.

¹ *As well as assessing the strength of the current covenant, assessments should be forward-looking and focus on the ability of the employer to contribute cash to the scheme over an appropriate period to achieve and maintain full funding based on an assessment of the employer's forecast cash flows and the medium and long-term outlook for the business and the market in which it operates.* Assessing and monitoring the employer covenant issued by the tPR August 2015

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11. We also note that Ofgem believes it would generally be inappropriate to penalise NWOs for not taking up liability management initiatives without specifying and consulting on the criteria for identifying such potential actions. In this context, we note that Ofgem acknowledges such a review of benefits and liability management is constrained by the scheme rules and the Protected Persons legislation. We will promote such initiatives where these are in the interests of customers and shareholders. Ofgem's proposal to support funding such initiatives is welcomed. Of course, decisions on liability management ultimately rest with the scheme trustees, guided by their legal obligations, and they will need to ensure that they make a proper assessment of the cost of any exercise against the prospective benefits of risk mitigation.

4. Scheme approach to risk

12. Trustees, rather than scheme sponsors, are primarily responsible for the scheme's approach to risk. Whilst the sponsoring company is consulted and can seek to influence the decisions taken by trustees, ultimately investment decisions are made by the trustees.
13. Ofgem recognises that risk management is a complex area and it would not be easy for consumers or their representatives to take a view on a constructive risk management approach. We note the suggestion that we should engage further and take into account the views of advisers, interested parties and informed academics. However we believe it is difficult to engage actively with customer representatives in any meaningful way on this issue. Indeed, it is particularly difficult to obtain views that are representative of all consumers. Different consumers, even supposing they understand the subject matter, will have different appetites for risk. Perhaps Ofgem would consider providing further guidance on how to view the customers' interest in this respect. One approach would be to accommodate the customers' interests by considering them as a different class of shareholder.
14. We believe that an appropriate degree of de-risking is a good objective for consumers as well as for pension scheme members. Underwriting scheme risks benefits consumers as well as shareholders and we think that schemes should move towards de-risking at opportune times, reflecting their increasing maturity. Whilst Ofgem's statement that it is inappropriate to assume de-risking is necessarily in the consumer interest may be true, we equally contend that not de-risking to remove volatility as the scheme matures is also not necessarily in the consumer interest. The absence of an explicit balancing statement that recognises that not de-risking may also be detrimental to the consumers' interests, raises the possibility that Ofgem wishes to
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discourage de-risking as an approach. We think that would be mistaken, but it would be helpful if Ofgem would clarify its position.

15. It is also important to remember that risk decisions are ultimately taken by trustees in the members' interests; as consultees we will continue to advocate the interest of customers and shareholders.

5. Surpluses

16. In principle we agree that, since the proposed funding arrangements mean that consumers stand behind the established deficit, it is right that consumers should be protected from any over-funding to which they have contributed.
17. We note that the consultation paper states that the probability of true stranded surplus occurring may be remote but we would like Ofgem to clarify the basis of a 'true stranded surplus': does this refer to a buy-out basis rather than a technical provisions basis? We believe the buy-out basis would be a more sensible test for the presence of a true surplus before any return from 'over-funding' is embarked upon. We would emphasise that, even if a technical provision surplus is reached, this will represent a deficit on buy-out basis. Moreover, the presence of any surplus cannot be regarded as a fixed position and market movements and demographic changes could change this position in relatively short periods of time. Surplus is not 'stranded' when it allows a lower risk strategy to be followed – the parties (members and consumers alike) having derived a benefit from the better funding position.
18. Ofgem suggests alternative funding mechanisms may be a possible solution to avoiding a stranded surplus, but given the unlikelihood of surpluses and the expense of alternative funding, we would suggest that this cannot, in most circumstances, be justified in the short and medium term.

6. Trustee role and the Pensions Regulator's expectations

19. We are pleased to see Ofgem acknowledge in the consultation the primacy of the trustees' role to manage the pension scheme efficiently and that the trustees' duties are to their members.
20. We also acknowledge that the approach of the two regulators 'can' be compatible and aligned and this was recognised in the letter from the Pensions Regulator to the ENA. As we noted earlier, we can see situations that may reasonably occur that would test this compatibility and

without formal guidance from the Pensions Regulator we see a continuing potential for the misalignment of the two regulators' positions.

7. Regulatory corporate guidance

21. We note that Ofgem intends to introduce a requirement on NWOs to account to their stakeholders for their part in the governance of the pension schemes and how they protected the interests of consumers. Our position remains unchanged from our previous response on this matter.
22. We continue to engage with our group trustees in a constructive manner and we believe that we can demonstrate significant improvements over the last few years in the absence of a prescriptive regulatory requirement.
23. Ofgem's proposal represents a move away from regulatory governance towards something that is more like stakeholder engagement.
24. The proposed requirement to account for pension scheme governance through corporate governance disclosure is something that may have merit but, once again, Ofgem should recognise that since neither trustees nor company directors have a specific duty to consumers with respect to the governance of pension schemes, any requirements for further corporate governance disclosure must be framed in such a way that they are able to subsist with the primary statutory requirements that bear on trustees and company directors. It would be helpful to hear what Ofgem would envisage in the (hypothetical) situation that a proposal that in the Company's view would improve scheme governance is for some reason rejected by the trustees.

8. Proposed approach for revising Pension Scheme Established Deficit repair allowances (EDE and SOEDE)

25. In our response to the last consultation we requested further detail on the proposals for determining allowances and repair plans and offered a potential mechanism to be applied.
26. Whilst our mechanism has not been adopted, we welcome the clarity now being provided on the basis of the future determination of allowances. Our detailed comments on this are provided at Appendix 2.

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27. In principle, we support the proposals but this endorsement is conditional upon the trustees and the Pension Regulator also adopting the proposals. Whilst we note that the Pensions Regulator has indicated that the two approaches of the regulators 'can be' compatible in terms of customers' and members' interests, this falls short of the endorsement of the proposed methodology. As we have commented previously, it may be in the short term that the mechanism can satisfy both interest groups and therefore be aligned; this alignment may not be possible if the repair period is stretched to 15 years at a future point without explicit approval from the Pensions Regulator.
 28. In this part of the consultation document there is no mention of rounding up the repair period calculation but this is contained in the handbook drafting. If rounding to whole years is necessary we suggest that rounding down will be more acceptable to the trustees.
 29. We also note in our detailed comments on the appendices that the principles and the handbook drafting are at odds on the period for spreading payment history adjustments. We are unclear why the current re-profiling of payment history over the period of the repair period has not been adopted, particularly since Ofgem has reserved the right to make a reasonableness adjustment for any undue benefit from front loading payment profiles.
 30. The mechanism for potentially funding, on an exception basis, major initiatives is a welcome development and this provides some needed flexibility in the now 8 year price review period.

9. Revisions to the Pensions Deficit Allocation Methodology (PDAM)

31. We understand Ofgem's rationale to amend the PDAM, however we believe the amendment 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 rather than as currently drafted where reference is made to the "value of future benefit accrual".
32. In addition, any adjustment to on-going contribution rates would also need to be reflected in the Totex calculation, the proposed wording for the financial handbook (paragraph 3.38 Appendix 2) does not clearly explain how Totex should be adjusted (if at all) for the amount by which contributions have been reduced on accounts of a PSED surplus.

10. Appendix 1 – Proposed revised guidance note on price control pension principles under RIIO

33. Paragraph 4 defines the Established Deficit. The following words have been added to the definition of liabilities: '...and any residual liability arising following a comprehensive pensioner buyout'. We would like to clarify if this addition to the definition is intended to change the basis of valuation from a technical provisions basis?
34. Paragraph 8 discusses protecting the consumer interest and we refer you to our comments on Governance in section 7 above and also to the problems of obtaining evidence-based insights into the interests of consumers.
35. Paragraph 21 suggests any under- or over-funding should be spread in line with the funding profile agreed for the deficit and we would concur; but in our response below on Appendix 2 we note that the handbook has not been drafted on this basis.

11. Appendix 2 – Proposed revised financial handbook chapter (ED1 example)

36. As noted in Section 5 above we believe that the calculation to determine whether the scheme is in a surplus position should reflect a valuation on a buy-out basis, the handbook should reflect that a negative adjustment would only apply when a surplus is calculated on such a basis.
37. It may be easier to deal with the signage issue in paragraphs 3.7 and 3.8 by defining PSED liabilities less assets.
38. The cross reference in paragraph 3.19(b) refers to paragraph 3.47: should this be 3.41 to 3.46?
39. Ofgem understandably has advanced the timetable in Table 3.2 for (i) receipt of the PDAM information; (ii) Ofgem's provisional decision and (iii) the opportunity to make representations. We would request the date for items in row 3 of table 3.1 to provide explanations and evidence on how we are supporting the interests of customers are submitted at the same time as the PDAM at the end of August to reduce the burden of information that needs to be submitted on 31 July.
40. Paragraph 3.24, 3.26 and 3.37 should simply state 2012/13 prices rather than introduce a cross-reference that will need maintaining.
41. We have previously agreed repair plans that run for a number of years and months so do not see the need to round up the years as detailed in paragraph 3.28, and an unrounded approach

would result in the same annual PSED in paragraph 3.30. This will be more acceptable to trustees rather than the gradual reduction that this rounding creates. If rounding to years is required for Ofgem modelling purposes, we would propose rounding down.

42. All the terms in the formula are not set out in paragraph 3.30 and the later paragraphs, Ofgem may be placing a reliance on certain terms already having been defined in earlier paragraphs but this approach is inconsistently applied.
43. The $(1-CT_{rr+1})$ formula at paragraph 3.37 will not work if the payment history allowance is spread over years other than just year $rr+1$, if there are different CT rates in force.
44. The formula at the top of page 40 is not set out clearly; presumably E_y should be a new sentence.
45. Paragraph 3.38 states that 'positive components of D_y should be excluded from Totex and negative components of D_y should be included as additions to Totex'. We agree it is important that there is no double count with totex but we find the wording potentially confusing. We would propose a statement 'Totex should be adjusted to exclude D_y ' and include a cross reference to the relevant section of the handbook (chapter 6), which will also need to be amended.
46. Surplus word at the beginning of the definition $WACC_y$ either 'the' or 'a' needs deleting.
47. A similar note to the table needs adding to Table 3.2 as that for Table 3.1.
48. We are unclear why the current re-profiling of payment history over the period of the repair period has not been adopted, particularly since Ofgem has reserved the right to make a reasonableness adjustment for any undue benefit from front loading payment profiles as set out in paragraph 3.43(b). The pension principles at Appendix 1 paragraph 21 suggest that the adjustment should be spread in line with the repair period determined for the PSED.