Mr W McKenzie
Senior Manager, Regulatory Finance
Ofgem
9 Millbank
London
SW1P 3GE

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Dear Bill

**Reasonableness review of energy network operators' pension costs**

We are writing with our comments on Ofgem's open letter of 28 October 2013 setting out proposals for the forthcoming review of the reasonableness of network operators' pension costs.

**Context**

Aon Hewitt are actuarial advisers to a significant proportion of the regulated electricity industry's pension arrangements, either as Scheme Actuary to Group Trustees or as actuarial adviser to the network operator. We also have a small number of other relationships advising stakeholders in the energy industry including the Energy Networks Association. However, we are responding to Ofgem's consultation solely as pensions consultants with particular interest in the pension arrangements for this industry and not on behalf of any specific clients.

**Engagement with Trustees**

We welcome Ofgem's recognition of the key role of pension scheme trustees and their responsibilities and independence, and its invitation to engage with trustees in the process of gathering information about the actuarial valuations to be used in its reasonableness review.

Aon Hewitt welcome Ofgem's desire to engage with a wide range of stakeholders and to seek information regarding assumptions or other decisions regarding funding or investment strategy that may initially appear to be outliers.

Ofgem should expect that trustee boards are likely to show different levels of willingness to take part in this process, and it would be wrong to penalise or "to be suspicious" of those network operators that are not able to share information with Ofgem, for example on covenant reports, neutral estimates or value at risk, if this is not made available by trustees.

Ofgem must also have regard to both the independence of trustees and the need to comply with pension legislation and the Pension Regulator's codes of practice and guidance. Ofgem appropriately acknowledge this under the Objective in the covering letter but it is less clear that the logic of this is followed through into some later comments. For example, there is a proposal that consumers should be effectively recognised as a primary stakeholder in setting funding and investment strategies but it is the trustees who determine the investment strategy and they have no duty directly to consider consumers.

Ofgem should recognise that the trustees' primary responsibility is to their pension scheme members. Trustees view the strength of the employer covenant as an important part of the security backing the pension scheme. Within this they recognise that the pension costs that can be passed through to consumers are an important part (although not the only part) of the affordability of employer contributions to the pension scheme. The trustee boards can only take consumers interests into account to the extent that doing so will strengthen the employer's covenant. They cannot recognise the consumers' interests directly as 'major stakeholders in the valuations'. This is in effect enshrined in legislation.

**In depth analysis v overview**

Aon Hewitt welcome Ofgem's desire to seek information in order better to understand what may initially appear to be outliers.

The level of data does though need to be proportionate to the purpose and interpreted appropriately. The main purpose of the pension information appears to be to test the cost efficiency resulting from the funding and investment strategies. There is an inherent tension between reducing expected funding costs and reducing the level of volatility/risk. This means that whilst there could be some inefficient solutions, which should be addressed, there is no uniquely correct approach. In collecting and comparing in depth figures and analysis, whether forward looking projections or historic performance returns, care will therefore need to be taken to avoid erroneous conclusions around the efficiency of a particular strategy.

**Timetabling**

We note that Ofgem acknowledges that the reasonableness process might not complete by 31 March 2015, and welcome the confirmation that adjustments will be back-dated as necessary. We are already seeing a tension building between trustees and companies as to when increased deficit contributions should commence in relation to 2013 valuations. From the companies' perspective accelerated deficit contributions appear to have a significant cost of capital attached to them which is not fully compensated for under Ofgem's pensions principles. However, the use of alternative funding mechanisms also have to pass an Ofgem efficiency test, with limited likelihood of acceptance. We would ask Ofgem to review arrangements in this area.

We also believe that many trustee boards are unlikely to want any dialogue with Ofgem until they have completed their funding valuation. Although some trustee boards could be ready for this interaction in Quarter 2 2014, others may not be ready until Quarter 3 2014.

**Covenant reports**

Many trustee boards are likely to have concerns about releasing covenant reports provided to them for a specific purpose during the valuation because these may not have been fully shared with the network operator. We do not believe that the refusal to provide this information should lead to 'adverse inferences' for the associated network operator because they have no control over the release of these documents. We believe that Ofgem will receive significantly more covenant information in the normal course of its regulation and could also refer to public domain information such as credit ratings and be able to use this to draw their own conclusions about covenant.

**Neutral estimate**

Although we believe that comparison against the neutral estimate could indicate areas suitable for further investigation, we wish to draw Ofgem's attention to the fact that:

- the neutral estimate is advice provided by the Scheme Actuary to meet a professional guidance requirement and is not part of the pensions funding regulations or the Pensions Regulator's guidance
- the neutral estimate may not have been shared by the trustees with the company during the process
- the company may not agree with the Scheme Actuary's assessment of the neutral estimate
- the trustee boards may not have given a great deal of focus to the neutral estimate as it does not drive contributions, or the technical provisions.
- a wide variety of neutral estimates can be constructed for the same scheme, for example depending on whether future derisking of the investment strategy is or is not reflected in the neutral estimate.

**Value at Risk**

Although we believe that value at risk analysis will provide some indication of the level of risk being taken, we have significant concerns that meaningful comparisons will not be possible because:

- most value at risk analysis would be undertaken over a shorter period than the 15 year funding period proposed by Ofgem
- there is a wide variety of modelling approaches and assumptions used in value at risk analysis
- the depth of modelling undertaken may vary significantly, and given the aim not to increase the costs of advice to the scheme, it will be difficult to find a standard set of information to gather.
- comparing risk outcomes would obviously need to be considered against the background of the expected cost impact
- quite different outcomes would be obtained based on the current investment strategy (as currently proposed by Ofgem) or allowing for any intended de-risking programme.

If Ofgem has a view on what an appropriate level of investment risk might be from a consumers' perspective both during and at the end of the original 15 year deficit repair periods, it would be very helpful to trustees and network operators in meeting the needs of consumers if Ofgem were to articulate this.

**Market comparisons**

It is sensible for Ofgem to compare the benefits and approach to funding provided by network operators with each other and with the broader market but in doing so this should recognise the restrictions imposed by the Protected Persons Regulations and each pension scheme's Scheme Rules.

Overall we believe the consultation and process of pension price control has been carefully thought through and compares favourably to some other industry regulators. We note that the thrust of the Ofgem approach has recently been supported by the Competition Commission in its review following referral by the Utility Regulator of Northern Ireland of Northern Ireland Electricity's price control.

We would be happy to meet with Ofgem if you would like to discuss further any of the points raised.

Yours sincerely

Keith Lelliott FIA, Lynda Whitney FIA, Jason Eshelby FIA
Aon Hewitt Limited
DDI +44 (0)1372 73300
firstname.surname@aonhewitt.com

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