
# Plugging into change

**Laura Blows finds out how the National Grid UK Pension Scheme managed not one, but two ambitious projects at the same time – outsourcing and overhauling its investment strategy, while also splitting the DB scheme into three autonomous sections**

That moment of realisation when it dawns on you that you're no longer the dynamic, young whippersnapper you once were, but instead may actually be a bit old and set in your ways, can be a shock.

For those trustees managing the National Grid UK Pension Scheme (NGUKPS) that moment occurred when a number of new members joined the board.

The NGUKPS has four employer-nominated trustees, two independent trustees and six member-nominated trustees. In December 2014 three new member-nominated trustees, one new employer nominated trustee and a new chairman were appointed to the board.

At this time the contribution schedule with the sponsor regarding the March 2013 triennial valuation had only just been agreed, meaning the board was then moving onto reviewing its investment strategy, which had not been looked at since 2010.

What soon became apparent was the scheme's liability hedging of just 30 per cent being insufficient. "The new trustee board felt that inflation risk and interest rate risk was an unrewarded risk and they felt very uncomfortable that given the maturity of the scheme so little of that risk was hedged," NGUKPS chair Nigel Stapleton says.

The second issue noticed was the limited diversification of return-seeking assets. NGUKPS used an internal manager for £12 billion of its £17 billion worth of assets, "whom, although it had a skilled team, was unable to bring in people with the suitable skills to diversify the portfolio globally".

Finally, given the ongoing debate between active management and passive investment, all of NGUKPS' equities portfolio being actively managed was questioned.

**Changing investments**

As a result, in April 2015 it was decided that interest rates and inflation risk had to be hedged to a greater extent than was the case, and in order to get an appropriate risk profile (in terms of moving from an 80 per cent coverage on a Technical Provisions basis to 100 per cent without the sponsors paying a lot more money into the scheme), a more diversified, return-seeking portfolio was needed.

To achieve this aim, the decision was made in April 2015 to sell the internal investment management business, Aerion.

"When we looked at the skills within Aerion on liability-driven investment (LDI) we did not feel that a team of three could in any way have the comparable expertise of the really big external LDI players that dominate the UK institutional investment market," Stapleton explains.

Unlike the "salami slicing approach, where time is spent to select the best possible manager for each asset class, transferring the funds and then saying goodbye to the internal team", Stapleton says, Aerion was put up for sale "not as such to secure the highest price for Aerion but to get the least costly and most effective external management outcome and a buyer who was willing to take the staff and all the liabilities attached to Aerion, which included a long-term office lease as well as over 40 staff".

In August 2015 a deal was struck with LGIM to buy Aerion.

By December 2015, the £12 billion of assets under Aerion was transferred to LGIM (the remaining £5 billion already being with external managers), along with all Aerion's investment professionals, bar two who now form part of a newly-created NGUKPS CIO team.

LGIM since then has kept responsibility for NGUKPS' credit portfolio, and "has done a very accomplished job for us in moving that into a globally-diversified portfolio, and also moving some of it out of investment grade into alternative credit areas", Stapleton adds.

LGIM has also kept 25 per cent of the Aerion internally-managed equities portfolio that was transferred from active to passive. The other 50 per cent of the equity portfolio went to external global credit managers, including one focusing on emerging markets, and the final 25 per cent went to factor investment.

In parallel, the £5 billion that had already been outsourced was realigned, with 13 other external managers rationalised to seven.

The expectation was, as Aerion moved over to LGIM in December 2015, that the trustees would have a very considerable and demanding job, extending well into the next year, to complete a total rethink of what the return-seeking portfolio should look like.

**Sectionalisation**

However, the workload for 2016 became even more demanding, because in November 2015, a shock came the trustees' way. The sponsor informed the trustees that National Grid wanted to sell a majority stake in its UK gas distribution business. This area accounted for a third of the scheme's total liabilities, and the sponsor could only reasonably expect a buyer to pick up the pension assets and liabilities attributable to this part of their business, Stapleton explains.

Therefore National Grid proposed to the trustees to split the NGUKPS into three separate DB sections – one section for gas distribution, one section for gas transmission, and one section for the rest of the scheme members. This could only occur with trustee consent.

The deadline National Grid needed this sectionalisation to complete by was particularly tight, with the detailed terms by which it would be achieved needing to be confirmed by June 2016. "Our major objective was to ensure that the accrued benefits of every member were just as secure after the split," Stapleton explains.

The first significant hurdle was splitting the membership.

"There was no way we had a documentation for every person that clearly shows whether he or she should be a member of gas distribution or a member of gas transmission, for example," Stapleton explains. To overcome this problem, a bespoke process to allocate assets and liabilities to the three sections was devised. This included a carefully-developed and tested methodology by which to allocate members whose history was inadequate to determine their section.

The second biggest challenge was addressing the fact that each of the autonomous sections would have different covenants compared to NGUKPS being one single scheme. In this respect, the trustees took considerable legal and covenant advice, to reassure themselves that members would not be affected adversely, in either accrued benefits or security, following sectionalisation.

Despite all these complications, a mere seven months later, by June 2016, the trustees had successfully negotiated with National Grid a guarantee and funding structure, along with appropriate contingent asset support.

"A delay in doing so would have had implications for a strategic initiative that was vital for the company. So we had a pretty strong hand in negotiating terms." Stapleton says. "The discussions were tough but strong relationships were maintained throughout and I believe the outcome was a win-win for both the sponsors and our members."

The successful negotiations were aided by support from professional advisers, "because clearly our executive team had neither the skills nor the depth to be able to deal with issues of such complexity, which for most schemes don't come up in 50 years", Stapleton explains.

**Implementation**

The second half of 2016 was spent implementing the many changes necessary to effect sectionalisation. This included valuing the whole scheme assets and allocating these between the new sections.

Most importantly, a significant member engagement programme was launched with the help of a media communications consultant, using a mix of traditional methods, such as mailings and a dedicated telephone help line, alongside innovative methods, such as online videos and animations.

To implement both the new investment strategy and sectionalisation, 59 meetings of the trustee board were required during 2016, along with the formation of two ad hoc sub-committees and many more teleconferences and email exchanges.

Sectionalisation came into effect on 31 December 2016. However, more implementation work lay ahead. Major aspects of scheme governance and reporting, sectional investment strategies, member administration, communications and auditing required redesign.

The MNT representation was also deemed inappropriate because it had been based on geography and member type. The election process was revised and in February 2018 the members of each section voted for two members of that section to join the reconstituted board on 1 April.

For Stapleton the 'bitter/sweet' of all this is that the elections meant that at least two of the MNTs who helped implement the changes are leaving the board with the term for which they were elected in December 2014 less than two-thirds completed.

**A worthwhile endeavour**

The two projects may have required considerable effort to completely overhaul all aspects of the scheme, but the results already seem to prove its worth. The trustees can demonstrate that these initiatives have materially reduced the scheme deficit as compared with what it would have been had the pre-April 2015 investment strategy and governance remained in place.

Members also seem happy, as evidenced by the positive feedback and the statistically tiny number of queries that amounted to less than 0.1 per cent of the membership. And possibly best of all, "we would certainly take the view that the contingent asset and other sponsor support now in place for the three sections is in total stronger than it was before the scheme was sectionalised", Stapleton says.

Managing two ambitious, overlapping projects may have been a challenge for the trustees, but it has clearly sparked a new lease of life into the NGUKPS.

**Written by Laura Blows**