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Price Control Pension Principles
Third consultation document

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Target audience: Consumers and their representatives, electricity and gas distribution network operators (DNOs and GDNs), transmission network owners and operators (TOs), employees and trade unions, energy suppliers and any other interested parties.

Overview: Ofgem regulates the electricity and gas network monopolies to protect the interests of present and future consumers. We set a price control every five years for each group of network operators (NWOs). The price control sets the total revenue allowances that each NWO can collect from customers and places incentives on them to innovate and find more efficient ways to provide an appropriate level of network capacity, security, reliability and quality of service. As part of setting revenues, we consider the treatment of pension costs. This, our third consultation document, sets out the Authority's minded to position on the treatment of pension costs in all future network price controls.

Subject to this consultation, we will use this approach in setting the allowances under current electricity distribution price review (DPCR5) which cover the period 2010-15. They will then be applied in the next gas and electricity transmission reviews and the gas distribution price control review.

We would welcome views on the minded to position set out in this document. We will hold a seminar on the 9 November to discuss these issues and aim to publish our decision later this year as part of the Final Proposals for DPCR5.

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Context

Ofgem’s principal objective is to protect the interests of current and future consumers. We regulate the network operators (NWOs) by setting a price control every five years. We also regulate the structure of their network charges, i.e. how they recover these revenues from different customer groups (such as business and domestic customers). As part of setting the total revenue, we consider the treatment of pension costs.

In 2003, we set out our principles for the treatment of pension costs and have applied these through three price controls - electricity distribution, gas and electricity transmission and gas distribution. After one full round of price controls we launched a review of the application of these principles. This was partly driven by recent developments in the wider pension environment such as changes that were being made to pension arrangements in both the public and private sector. We consulted in August last year and again in July this year. We sought views on whether we were applying these principles effectively and whether they were delivering a fair deal to customers, shareholders and employees in the companies. We also held two stakeholder workshops. Following last year's consultation, all network operators were asked to submit details of their pension schemes. We commissioned and published the Government Actuary's Department review of that information, together with the completed questionnaires. We have liaised with other utility regulators, the Competition Commission and with the Pensions Regulator (TPR) during our review.

Our aim is to ensure that NWOs continue to manage their pension costs effectively on customer's behalf. We also want to make sure that our arrangements lead to similar incentives on NWOs as other regulated and unregulated companies so that pension arrangements for energy networks track what is happening in other comparable companies over time.

Although this review of our approach to applying the principles covers all the price controlled energy networks, it is particularly relevant for the DNOs, as we are now undertaking a review (DPCR5) to set the price controls for the DNOs for 2010-2015. In this document, we set out the Authority's minded to position on how it intends to treat pension costs in all future price controls and in the final proposals for DPCR5.

We will set out our final decision on the treatment of pension costs for DPCR5 in the Final Proposals due to be published at the end of this year. We will also publish a short document setting out how we will apply the principles to future price controls - the next electricity and gas transmission price control review (TPCR5) and the gas distribution review (GDPCR2). We will consult at each of these reviews on any issues specific to them.

Associated Documents

- Developing Network Monopoly Price Controls May 2003 (54/03)http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=41&refer=Networks/Policy

- Distribution Price Control Review 4 – Final Proposals (265/04)
  http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=51&refer=Networks/ElecDist/PriceCntrls/DPCR4

- Gas Distribution Price Control Review Final Proposals Consultation Document (285/07)
  http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=362&refer=Networks/GasDistr/GDPCR7-13

- Transmission Price Control Review: Final Proposals (206/06)
  http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=191&refer=Networks/Trans/PriceControls/TPCR4/ConsultationDecisionsResponses

- DPCR5 Price Control Review Policy Paper (159/08)
  http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=132&refer=Networks/ElecDist/PriceCntrls/DPCR5

- Price Control Pension Principles consultation document (120/08)
  http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=Pension Consultation 2008 final v2.pdf&refer=Networks/ElecDist/PriceCntrls/DPCR5

  Open Letter: Price Control Pension Principles Questionnaire
  http://www.ofgem.gov.uk/Networks/Documents1/Pension per cent20questionnaire per cent20covering per cent20letter.pdf

- Price Control Pension Principles second consultation document (96/09)
  http://www.ofgem.gov.uk/Networks/Documents1/Price per cent20control per cent20pension per cent20principles per cent20second per cent20FINAL.pdf

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Summary

Our principal objective is to protect the interests of present and future consumers. For the monopoly energy network operators (NWOs), this means regulating their revenues, the charges customers pay and the quality of service. This includes the treatment of pension costs. In recent years, they have accounted for an increasing portion of total costs, largely driven by the rise in annual deficit repair payments.

The issues associated with managing the historical liabilities and the ongoing costs of pension provision are being faced throughout the UK economy by private sector companies, public bodies and other organisations. Our current approach to pension costs differs from that adopted by other utility regulators. We usually set revenue allowances in line with the NWOs' forecast of pension costs, adjusting allowed revenues at the end of a control period to account for any differences between these allowances and actual expenditure. Although there may be valid reasons for different treatment, for example legislative arrangements put in place at privatisation, we think our current approach may not in practice provide the same incentives on NWOs to manage existing and future pension liabilities that other comparable, large UK companies face.

We have been consulting on the treatment of pension costs for NWOs since August 2008. Having run a seminar, reviewed the responses to the consultation and considered the matter further, we issued a second consultation in July 2009. This set out a range of possible options for treating pension costs in future price controls. In addition to retaining our current approach to pensions, the options involved introducing incentives for NWOs on some (or all) of the different categories of costs: liabilities for past pension provision; the ongoing costs (and any incremental deficit that subsequently arises) of defined benefit schemes; and the cost of servicing a defined contribution scheme. We suggested it might be appropriate to introduce varying strengths of incentives across these three categories of pensions costs, reflecting the different level of influence and control that NWOs management and shareholders have over them.

In this our third and final consultation, we set out our minded to position for DPCR5 and subsequent reviews of transmission and gas distribution. Some respondents have argued we should not change our current approach. We do not agree and are minded to make some changes to our current treatment of pension costs. We have listened carefully to the views expressed in response to our consultation documents and at our seminars. Pension trustees, companies and union representatives have argued strongly that research conducted for us by the Government Actuary's Department (GAD) suggests that there is not a problem and we should maintain our current approach. Centrica and some customer representatives have argued that we should make changes to make sure that pension costs (and arrangements) continue to track those in other companies and the wider economy in future.

We are minded to make changes for two principal reasons. First to make sure we are meeting our principal duty to protect the interests of consumers, so that present domestic and business consumers are not paying more than they need to repair existing deficits at a time when energy bills are high and rising and the economy is in a deep recession. The second is to make sure that pension costs do not become a

problem at future reviews and that we put in place incentives on companies to continue to manage their pension costs and pension arrangements effectively in future.

As set out in our previous consultation, we think it is appropriate to separate out the costs of repairing any deficits in pension schemes from the costs of funding ongoing pension contributions and to apply different treatment to these different categories.

For ongoing costs, we are minded to apply benchmarking of total employment costs (including pensions) along with total costs to set revenue allowances in all future price controls. NWOs will remain free to choose whatever pension arrangements they think are appropriate to attract and retain staff. But in setting funding, we will benchmark their total employment costs against other NWOs and comparable private sector companies. However, at this stage in the DPCR5 process, it is not practical to include ongoing pension costs into our benchmarking exercise. For DPCR5 only, we are minded to allow the DNOs their forecast ongoing pension cost and to apply an incentive mechanism where they will share the benefit or cost of any movement from the forecast to their actual level of pension costs.

We are minded to set a longer notional period for funding pension deficits for all schemes of 15 years whilst maintaining our commitment to fund fully these deficits as long as they continue to be managed efficiently. We are also minded to provide further guidance on the application of our existing principle of only allowing economic and efficient pension costs when assessing deficits at subsequent price controls. We are minded to use the Pension Protection Fund 7800 index to assess whether to undertake an ex post efficiency review of deficits at future controls. If a company's deficit has moved significantly out of line with movements in that index over the price control period we will carry out a review. This review will place the onus on the company to demonstrate that their deficit costs have been efficiently managed and to explain why their scheme deficit has not moved in line with other scheme deficits. If they are unable to demonstrate this, then we may not fund all (or part) of any additional costs over the allowances through the price control. Shareholders will have to fund any disallowed costs.

We do not have any power to reform energy workers’ pension rights and we are not seeking to do so. Pension rights are determined by energy workers, the management and shareholders of energy companies and each scheme’s pension trustees. However, through our five-year price controls for network companies, we determine the financial incentives on these companies to manage all of their costs – which are paid for by customers - including pension costs. In setting price controls our aim is to strike a fair balance between the needs of the companies, employees and customers.

Our proposals are designed to provide regulated monopoly energy networks with the same incentives as other regulated and unregulated companies to manage their existing (and future) pension costs and liabilities. This should ensure that the pension costs of the energy networks remain efficient. We also think our proposals are fully consistent with the rules established by the Pensions Regulator.

We would welcome views and will continue to consider responses carefully before coming to a final decision at the end of this year.

1. Overview of minded to position

Chapter Summary

This chapter sets out an overview of our minded to position for the treatment of pension costs and summarises the process we will follow in reaching a final decision on this matter.

Process

1.1. This document is our third consultation on the application of our pension principles. It sets out our minded to position on the treatment of pension costs in DPCR5 and for incentivising network operators (NWOs) to efficiently manage their pension costs in all future price control reviews. It follows on from the two previous consultations in August 2008 and July 2009 and the seminars in October 2008 and September 2009.

1.2. We had a good level of response to the second consultation with 20 respondents across all stakeholder groups. Appendix 2 provides a summary of responses and an overview of the seminar held on 8 September 2009. We have listened and considered carefully responses to the documents and the views expressed at the seminars. We have met with trade union representatives twice and the DNOs have had an opportunity to make direct representations to the Authority on the matter of pensions. Other NWOs have also been involved at each of the consultation stages.

1.3. Before reaching our decision we will hold another seminar with interested parties on 9 November 2009[1]. This workshop will provide all interested stakeholders with a further opportunity to raise any issues they have regarding the Authority's minded to position on our price control pension principles.

1.4. We will set out our conclusions on how we intend to treat pension costs in DPCR5 in the Final Proposals due to be published at the end of this year. We will also publish a short document that provides a clear statement of our pension principles and how we intend to apply them at all subsequent price control reviews. We will consult at each subsequent review on any pension issues specific to that review.

1.5. The consultation period on our minded to position on price control pension principles will be four weeks, to allow us time to consider responses ahead of DPCR5 Final Proposals. While we are committed to offering a six-week consultation period

[1] Price Control Pension principles third seminar
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=87&refer=Networks

wherever possible, we consider that a shorter, four-week consultation period is reasonable in the circumstances given the extensive consultation and stakeholder engagement that have preceded us reaching our "minded to" position.

Overview of minded to position

1.6. Our existing treatment for pension costs is to set ex ante allowances for both ongoing pension costs and deficit repair payments in accordance with our pension principles (set out in appendix 3) with a full adjustment for any differences between the upfront allowances to actual cash costs incurred by NWOs subject to them being economic and efficient. But in practice we have found it very difficult to effectively assess whether the economic and efficient test is passed. So the arrangements have effectively lead to a pass through of actual pensions costs.

1.7. In July[2], we developed separate options for the treatment of deficit repair costs and ongoing pension costs. We did this because different issues apply across these two categories and in recognition that management does not have the same degree of influence over current liabilities as it does over ongoing costs. We set out below our minded to position for these two categories. In Chapter 3, we set out in more detail the factors we have considered in arriving at our minded to position.

Ongoing pension costs

1.8. Ongoing pension costs should be treated in the same way we treat all other network costs. Each network operator's revenue allowance will be set having benchmarked all costs, including ongoing pension costs and other employment costs. We consider this is consistent with our first pension principle "… providing a competitive package of pay and other benefits, including pensions … in line with comparative benchmarks". This also means the regulatory arrangements will not directly influence management decisions on the balance of pensions, pay and other benefits in the employment package they offer. Network companies will be free to negotiate with staff and trade unions to maintain existing arrangements or to put in place whatever pension arrangements they consider appropriate. But the revenue allowances will place a strong incentive on the company to manage the total costs of running the business including total employment costs.

1.9. At this stage in the DPCR5 process, it is not practical to include ongoing pension costs into our benchmarking exercise. For the DPCR5 review only, we are minded to

[2] Price Control Pension Principles second consultation document (96/09) http://www.ofgem.gov.uk/Networks/Documents1/Price per cent20control per cent20pension per cent20principles per cent20second per cent20FINAL.pdf

set revenue allowances based on the companies' forecasts for ongoing costs (after our normal amendments), with the DNOs exposed to a share of any over expenditure against this allowance, or able to retain a share of any savings made from this allowance. Our current thoughts on the appropriate sharing factor are set out in more detail in Chapter 3.

Historic liabilities

1.10. There are three key elements to our minded to position with regard to the costs associated with historic liabilities.

1.11. First, we are minded to set allowances in respect of deficit repair using a notional funding period for all network companies. We are minded to set this period at 15 years. We would welcome views on whether we should set 10 years as the minimum or use a figure between these two numbers. Our decision in this respect has an impact only on the timing over which deficit repair costs would be recovered from customers, and would not undermine Ofgem's commitment to ensuring that network companies can fund fully existing liabilities subject to our efficiency test.

1.12. We think our proposal represents a sustainable funding approach to pension liabilities. We have confirmed our strong commitment to continuing to fund fully all efficiently incurred pension costs. But there is, in the light of the recent turmoil in financial markets, considerable uncertainty over the size of the deficits. Customers - both business and domestic - are facing high (and rising) energy bills during a deep recession. In addition, distribution charges are set to rise significantly over the next five years. So we think it is appropriate and fair, given all these factors, to commit to pay off these deficits over a longer time period.

1.13. Second, in the context of the recent volatile market conditions we are minded to set allowances based on the most up-to-date actuarial valuation of the deficit, rather than the last full valuation. Licensees are, in any case, required to provide up-to-date actuarial calculations (including the most recent formal actual valuation) and for DPCR5 we have already requested an update at 30 September 2009. We are minded to use this as, when market conditions are uncertain, the latest update should be the best indicator of deficits at 31 March 2010. This approach complies with principle 4 "Licensees are required to provide up-to-date actuarial calculations"

1.14. Finally, we think it is appropriate that we clarify how we will apply the "economic and efficient" test at the end of each price control. We make adjustments at the end of a price control period so that the network company can recover all "economic and efficient" pension costs irrespective of the allowance set at the start of the control. For example, where a company's actual deficit funding costs have exceeded the allowance granted at the beginning of the period, the company may be eligible for the difference to be funded in the next period, as long as these costs are "economic and efficient"[3].

1.15. We have not previously clarified how we will assess whether a company's pension costs are economic and efficient. In recent reviews, we have tended to fund (or clawback) the full amount of the difference between the allowance and companies' costs without subjecting these costs to a thorough review. As pension costs rise, and bearing in mind our primary duty to customers, we think it is important that we are able to apply this test effectively.

1.16. At the end of the control period, or in any case no longer than five years after the initial allowance was set, we are minded to assess the movement in the value of each company's pension scheme against movements in the Pension Protection Fund 7800 index. This index tracks movements across around 7,400 pension funds. Our proposal is that if a company's pension assets or liabilities move more than 5 per cent above or below movements in the index, this would trigger a review.

1.17. If the companies deficits were higher than that indicated by the index it would be for the network company concerned to demonstrate that it had managed its pension fund effectively and efficiently on behalf of consumers. If it cannot do so, then the company may have to bear some or all of the extra pension deficit costs it has incurred over the previous price control period.

1.18. If the companies' deficits were lower than the index and the company could demonstrate this was due to efficiency savings then they would be able to retain a proportion or all of the difference in those efficiency savings.

1.19. We recognise that there could be a variety of good reasons why the deficit of a well-managed pension fund might move out of line with the PPF7800 index. For example - different maturity profile to other schemes and mix of investments to match liabilities. We will not, therefore, automatically disallow the additional pension costs for those companies whose funds move out of line with the index. In establishing this review trigger, we are only clarifying the trigger for us to take a closer look at how a pension fund has been managed. And to place the onus on the company - and not Ofgem - to demonstrate the additional costs are efficient. We think this reduces the risks of how we would true up ex post compared with our current approach where there is no guidance and no specified trigger for an efficiency review.

1.20. In setting this trigger we want to be clear that it is not our intention to interfere or influence in any way the investment decisions made by pension trustees.

[3] Conversely, if assets have increased or deficit funding costs fallen then the benefit of these could be passed back to customers in the next review period.

Structure of document

1.21. In the following chapter, we set out the background to this review and recent developments in pensions. In Chapter 3, we summarise the issues and risks we have considered in arriving at our minded to position. Finally, we set out our position on various application issues in chapter 4. At appendix 3 we set out updated pension principles based on our minded to position and the methodologies for calculating the regulatory fraction in DPCR5, the DPCR4 ex post adjustment and the movements in early retirement deficiency contributions (ERDCs). The latter were also previously published in our update to the DPCR5 Initial Proposals on 5 October 2009[4], but they have not been explicitly sent to TOs and GDNs or other stakeholders.

[4] Electricity Distribution Price Control Review - October update covering letter http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=323&refer=Networks/ElecDist/PriceCntrls/DPCR5

2. Background

Chapter Summary

This chapter sets out the background to the review of the application of our pension principles, including recent developments in the pension environment.

Background

2.1. Our approach to the treatment of pensions within price controls is to have a core set of principles for all distribution and transmission licensees to be applied consistently subject to the different contexts of each price control review. These principles were first developed in our *Developing Network Monopoly Price Controls May 2003*[5] *document.* We have applied these with minor refinements through three price controls - electricity distribution (DPCR4), transmission (TPCR4) and gas distribution (GDPCR)[6]. They were set out in the previous consultation documents and an updated set based on our minded to position is set out in appendix 3.

2.2. Pensions are important because their costs represent a significant proportion of NWOs' total costs amounting to about 15 per cent in DPCR5 (based on our 5 October update[7]). They are also rising significantly. We have a primary statutory duty to protect current and future consumers and in carrying out this duty, we must have regard to the need to secure that efficient and economic NWOs are financeable. We have a responsibility to balance these statutory duties.

2.3. Given the changes in the UK pension environment, we initiated this review of the working of the 2003 principles and have consulted on the way in which we apply

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[5] Developing Network Monopoly Price Controls May 2003(54/03)
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=41&refer=Networks/Policy

[6] Distribution Price Control Review 4 – Final Proposals (265/04)
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=51&refer=Networks/ElecDist/PriceCntrls/DPCR4
Gas Distribution Price Control Review Final Proposals Consultation Document (285/07)
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=362&refer=Networks/GasDistr/GDPCR7-13
Transmission Price Control Review: Final Proposals (206/06)
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=191&refer=Networks/Trans/PriceControls/TPCR4/ConsultationDecisionsResponses

[7] Electricity Distribution Price Control Review Initial Proposals (92/09)
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=260&refer=Networks/ElecDist/PriceCntrls/DPCR5

them. One of the consequences of the move from the minimum funding requirement to scheme specific funding by the Pension Act 2004 has been shorter deficit repair periods and an increase in the level of annual deficit payments increase. One of the key issues the review has considered is whether we should continue with our current approach. This puts the onus on us to review information submitted by the NWOs and to make judgements of how efficiently they are running their schemes. The alternative is to introduce some form of incentive(s) on NWOs to manage their existing and future pension liabilities, recognising that any change in approach would need to strike an appropriate balance of deficit funding between NWO's shareholders and consumers, whilst ensuring that scheme members are protected.

2.4. Our concern has been that our existing approach may not adequately place the same incentives on NWOs that are faced by other regulated and unregulated private sector companies to manage pension costs. Since the start of the consultation process, there has been a notable trend by private sector employers to amend their pension arrangements. This includes amending the rules to base pension rights on career average earnings rather than final salaries, or reducing the accrual rate for years of service from 1/60th per year to 1/80th per year. Others have sought higher contributions from employees. Some of these changes have also been put in place in the public sector through a series of reforms to civil service pension arrangements.

2.5. Previous documents in the review set out the background to the schemes and certain legal protections on pension benefits that were put in place at privatisation. They also set out some of the most significant developments in the UK pension environment since 2003 when the principles were set. DNOs and TOs in particular regard the funding of pension deficits in part as a legacy issue from the arrangements put in place at privatisation. All except one of the schemes are now effectively closed to new employees. Since we set the principles, there has been a sharp rise in employer contribution rates and deficit repair payments driven in part by the recent turmoil in financial markets that have reduced the value of scheme assets, changes in gilt rates that are used to assess future liabilities and increased longevity.

2.6. During the course of the consultation process, some respondents have highlighted the constraints on NWOs seeking to make changes in benefits, due to the legislative protection given to members of the electricity schemes at privatisation and the scheme rules that apply to the gas schemes. Changes to benefits are only one way of managing the costs of pension schemes (or of employment costs more generally) and we do not seek to encourage particular actions by NWOs, only to ensure that they manage the costs of existing and future liabilities. We recognise that for some of the schemes these incentives are likely to be in place as some of the schemes of which NWOs are sponsors also include members who work in other sectors of the industry that are now competitive markets.

2.7. We previously observed that, under the current application of our pension principles, we appear to expose network companies to less risk than broadly comparable regulated companies. We acknowledge that this arises, in part, from the different regulators' duties and responsibilities, but also the historical background, where in some industries the legacy pensions were not passed to companies at privatisation. All other economic regulators, including the Competition Commission have a policy framework that leaves shareholders of the regulated company with at least some, and in certain cases all, of the risk attached to deficit funding. Whilst our principles mean that under certain circumstances unfunded early retirement deficiency contributions (ERDCs) and significant pension costs attached to the non-price controlled element of the business are not funded by customers, NWOs may be exposed to some risk, this is a contingent outcome, which many licensees may be able to avoid.

Recent developments

2.8. In the wider UK private sector, in the current economic climate and because deficits have in some cases exceeded some companies' market values, many companies have sought to reduce substantially their pension costs and, in particular, the cost of funding those burgeoning deficits.

2.9. Reflecting what has already happened in the electricity sector for the majority of schemes, many large schemes have now closed to new members with only three FTSE100 companies now having their defined benefit (DB) scheme open. But changes have gone beyond simply closing the schemes to new members. Some recent changes to DB schemes include:

Babcock International	Longevity risk transferred to capital markets
BP	Closed scheme to new members
Dairy Crest	Closed scheme
Barclays Bank	Closed scheme
American Express	Suspended all pension contributions
Morrisons	Replaced with career average scheme
Fujitsu	Proposed scheme closure
Royal Bank of Scotland	Reduced level at which benefits accrue
IBM	Closed scheme
Corus	Closed to new members
Balfour Beatty	Cap on amount of pay increase included in pensionable pay (including promotions)
Express Newspapers	Closed scheme

2.10. In electricity distribution, we have seen net deficits more than double since the previous valuations on which the DPCR4 allowances were based. In their latest forecasts for DPCR5, DNOs' scheme deficits have increased from the last triennial valuations which were at 31 March 2006 (for the two Scottish schemes) and for all others 2007, except ENW, 2008), by over 450 per cent to £5.5 billion[8].

[8] This figure is before adjusting for the regulatory fraction.

2.11. Since the Initial Proposals for DPCR5 were issued, the two DB schemes sponsored by Scottish Power DNO's have provided preliminary valuation and deficit data. The Scottish Power Pension Scheme (SPPS) is a full triennial valuation, whilst that for SP Manweb has been shortened to a two-year full valuation to be co-terminus with that for SPPS. Both these and that for Scottish Hydro Electric's valuation were set around the low point of recent movements in the FTSE100 index.

2.12. The PPF publishes the latest estimated funding position, on a Pension Act 2004 section 179 basis, for the defined benefit schemes in its eligible universe every month. This is their *7800 Index*. Their estimates are based on scheme valuation data, which has been adjusted to consistent dates on an approximate basis, using changes in market indices for principal asset classes, and the fixed interest and index-linked gilt yields used to value liabilities. As well as the changes in net deficits, this reports movements in assets and liabilities separately.

2.13. The August PPF7800 Index indicated a reduction in deficits from March to August 2009 of 28.5 per cent. The index now uses data on around 7,400 DB schemes and although individual NWO schemes may not match the asset profile of schemes in the index, it is a clear indication that deficits are likely to have reduced substantially since we obtained previously updated valuations from DNOs as at 31 March 2009.

2.14. During 2009, TPR published *Scheme funding and the employer covenant*[9], which suggest some alternative approaches to recovery plans other than extending the duration of scheme funding. These include, where employers are cash constrained, back-end loading of funding, which could include provision to accelerate funding if the employers financial position improved. Another alternative was a variety of contingent assets that could be secured, guarantees from related parties or third parties, security over assets or assets in escrow accounts. TPR considers trustees must ensure the scheme is treated fairly in relation to other creditors and equity providers and not disadvantaged. We note , however, that There are licence condition restrictions on NWOs providing security over some classes of assets unless for a permitted purpose.

2.15. The Pensions Act 2008 will from 2012, require that employers automatically enrol relevant workers into the Personal Accounts Scheme or the employer's own qualifying auto-enrolment pension scheme. The requirement is expected to be phased in over three years, with required contributions increasing over the transitional period. The total minimum contribution to the scheme will be 8 per cent of qualifying earnings, with a minimum 3 per cent contribution by employers and employees making up any shortfall. To be exempt from the requirement to auto-enrol in the Personal Accounts Scheme, employers' own auto-enrolment schemes will have to be certified as qualifying schemes. Employees have the option to opt-out.

[9] http://www.tpr.gov.uk/pdf/EmployerCovenantStatementJune2009.pdf

TPR will be responsible for enforcing employers' automatic enrolment, re-enrolment and opt-in obligations. We understand that DNOs have considered these requirements in their FPBQ submissions.

3. Review of our options in setting pension cost allowances and rationale for our minded to position.

Chapter Summary: In this chapter, we set out the options we put forward in the second consultation and provide an overview of the consultation responses. We set out the issues and risks around the options and explain the rationale for our minded to position.

Question 1: Do you agree that applying benchmarking to all employment costs (including ongoing pension costs) appropriately incentivises NWOs to manage those costs efficiently?

Question 2: Views are invited on whether our proposed treatment for DPCR5 is appropriate?

Question 3: What do you think would be an appropriate sharing factor to apply to ongoing pension costs in DPCR5?

Question 4: Do you agree with the proposal to introduce a notional deficit repair period for all network companies?

Question 5: Views are invited on whether 15 years is the appropriate notional funding period to protect consumers, or whether we should set 10 years as the minimum, or use a figure between these two numbers.

Question 6: Views are invited on whether using the latest updated, rather than the last full, valuation is the most appropriate given the recent volatile market conditions.

Question 7: Do you agree with our proposal to introduce a trigger for a review of the efficiency of companies' pension costs at the end of each price control period?

Question 8: Views are invited as to whether the PPF7800 index is an appropriate index to use as the trigger mechanism for a review of deficit movement**.**

Question 9: Do you think our minded to position overall achieves an appropriate balance between our duties to protect consumers and allow NWOs appropriate funding of pension deficits?

3.1. In our July consultation, we set out a number of options for setting price control pension cost allowances. In summary these are:

1. to maintain the status quo;

2. to allow NWOs the choice but with an adjustment to cost of capital for companies opting for the status quo as it significantly de-risks them (the menu option);

3. to defer the consideration of these issues to the RPI-X@20 project;

4. to introduce "incentives" on one, two or all three of the following elements, as follows:
- Deficit arising on accrued liabilities to date (which would be at the date of the relevant price control),
- The ongoing costs (and then any incremental deficit that subsequently arises) of a defined benefit scheme,
- The cost of servicing a defined contribution scheme.

3.2. Broadly speaking our options involved taking steps to set allowances for each of these cost categories, based on a view of efficient costs and incentivising the NWOs to manage their pension costs by allowing shareholders to keep a share of any cost savings they made or bearing a share of cost overruns.

3.3. For deficits we set out options relating to the choice of valuation, the repair period and a modest sharing factor on differences between actual and allowed contributions. For ongoing costs, our options consisted of setting upfront allowances with reference to expected contribution rates or benchmark data and choices over the appropriate sharing rate. We discuss the incentivisation options in more detail below.

3.4. We now set out the feedback we have had on each of these options and discuss the issues we have addressed in arriving at our minded to position.

Status Quo

3.5. The view of NWOs and the unions remains unchanged from that at the first consultation, which is to retain the status quo. They consider that NWOs are adequately incentivised by the existing arrangements and cite the Government Actuary's Department (GAD) report as evidence that their pension costs are being managed efficiently. Conversely, customers groups and Centrica argue that NWOs can do more to reduce pension costs and support some form of incentivisation.

3.6. Having carefully considered both sets of responses, we think that there are a number of reasons for not maintaining the status quo.

3.7. Our principal duty is to protect the interests of current and future customers. As set out earlier in Chapter 2 the costs of pensions are rising significantly and in our October update amount to some £2bn over the DPCR5 period accounting for around 15 per cent of total expenditure. This is a significant cost for consumers which needs to be considered in the context of the changing pensions environment; the difficult position that companies and consumers find themselves in at present and the increased costs in DPCR5 arising from the increased investment in the network.

3.8. The pensions environment is changing with most companies and public sector organisations having to consider difficult decisions surrounding their employment package including pensions, even trade unions. In chapter 2 we set out just a few examples of recent changes in pension provision and more recently there has been ongoing debate surrounding changes in retirement ages. Given that one of our aims of this review is to ensure that network businesses face similar pressures as non-regulated businesses we cannot make a case for maintaining the status quo, unless it also provides such pressure. We do not think it does.

3.9. The financial context is also important. The world economy is showing signs of emerging from a deep recession and this has left companies and consumers facing difficult decisions over budgets and expenditure. This coincides with an increase in expenditure in the network businesses with an average X of nearly 5 per cent per annum in our October update to Initial Proposals. In particular, as set out later in this chapter, the potential cost of deficit funding is very high in DPCR5.

3.10. With the increasing cost of pensions in DPCR5 contributing towards significantly increasing charges for consumers, we are concerned to ensure that we have arrangements in place to prevent pension costs becoming an even larger proportion of costs in the future.

3.11. Given the factors above we have a duty to take action if we believe we can make changes that are appropriate and that do not impinge on the rights and responsibilities of the trustees, nor expose NWOs to an unacceptable level of risk. We have also taken into consideration that our existing principles do not provide clarity on how we would judge whether any NWO's pension costs are efficiently incurred. A change from the status quo will enable us to provide additional clarity to NWOs and would, arguably, reduce the risk they would face if we maintained the status quo by providing more clarity and certainty on what would trigger an efficiency review of their pension costs that could lead to us disallowing all or part of any overspend relative to their allowance.

3.12. On balance, we consider that to protect consumers the status quo is not a reasonable option, particularly because of the material effect doing nothing will have on consumer's bills in DPCR5.

Menu regulation

3.13. Menu regulation would involve giving companies the choice whether to accept a greater degree of incentivisation, on the understanding that companies which opted for the status quo would receive a lower cost of capital than those agreeing to greater incentivisation. In theory, this option might, over the long term, have revealed the extent to which companies can manage their pension costs and have led to a better understanding of the trade-off between cost of capital and pension cost treatment.

3.14. In practice, however, this option was not favoured by NWOs. Many respondents have disputed the connection between the cost of capital and the regulatory treatment of pension costs. But a number of DNOs did cite the potential change in the treatment of pension costs as relevant to our decision on cost of capital when responding to DPCR5 Initial Proposals**.** The NWOs also made the point that they have limited control over the cost of past liabilities and use this to argue that it is inappropriate in any circumstance to introduce incentivisation around this element of pension costs.

3.15. As there is limited appetite amongst NWOs for this approach, we do not propose to proceed with this option.

Defer consideration of these issues to the RPI-X@20 project

3.16. We could defer addressing this issue and to consider it as part of our wider review of the way we regulate energy networks. While there has been some support from respondents for this approach, we consider there are a number of reasons against a deferral. In particular, we think there has been sufficient time to consider carefully all of the issues associated with pensions ahead of DPCR5 Final Proposals, given that we commenced this consultation process in August last year. With three consultation documents and three stakeholder seminars we think there has been sufficient time for all stakeholders to make their representations and to consider the options.

3.17. We are also concerned about the level of pension costs in DPCR5. If we asked the RPI-X@20 team to consider these issues further there would not be any change for electricity distribution companies until 2015. We think that if we adopt our minded to decision, this could lead to a reduction in the average price increases over DPCR5 of over 2.5 per cent over the five year period. Against the background of substantial rises in distribution prices and the general economic conditions we think it is reasonable to make the changes now to mitigate the impact on customers.

Review of incentive options

3.18. In the second consultation we set out the options in the table below and invited comments.

Table 3.1: Pension allowances and incentive options

Pension costs element	Existing approach (DPCR4)	Potential incentivisation	
		Ex ante	**Ex post**
I. Payment of any deficit arising on accrued liabilities to date (which would be at date of relevant price control)	Accept actuarial valuations (allowing full true-up) of regulated fractions, subject to ERDCs	(A) Accept funding of deficit at 31 March 2010, decision on using conformed valuations. (B) Decision to make on recovery periods, either:	Modest symmetric sharing factor – for example shareholders for example bear or gain 2 to 10 per cent of any difference between actual contributions and

<table>
<tr><td></td><td></td><td>(i) use actual deficit repair period of company scheme
(ii) use a notional deficit repair period</td><td>allowed contributions</td></tr>
<tr><td>II. The ongoing costs (and then any incremental deficit that subsequently arises) of a defined benefit scheme</td><td>Accept actuarially recommended contribution rates, apply to our estimate of salaries, full true-up</td><td rowspan="2">Allow NWOs a fixed allowance with no true up

Two options:
(1) Set allowances in line with expected contribution rates
(2) Benchmark and make fixed allowance based on either
(a) pension costs, or (b) total employment costs</td><td>Apply the same incentive rate as all other costs or a lower rate accepting NWOs have less control because of legislation.</td></tr>
<tr><td>III. The cost of servicing a defined contribution scheme</td><td>Accept existing rates, apply to our estimate of salaries, full true-up</td><td>Same incentive rate as all other costs including total employment costs</td></tr>
</table>

3.19. In the rest of this chapter, we set out our evaluation of the options in the table above and our rationale for our minded to position, turning first to the options around ongoing costs and then to the issues around pension deficit payments.

The ongoing costs of defined benefit and defined contribution schemes

3.20. The options we set out relating to ongoing pension costs involve setting an upfront allowance for each NWO and then applying an incentive rate to any over or under expenditure against that allowance. Within these broad arrangements we considered a range of ways in which we could set the upfront allowance (either with reference to a benchmark or in line with expected contribution rates). Similarly, we considered a range of different incentive rates for this category of costs.

3.21. This broad approach was supported by one respondent, Centrica. Most other respondents preferred the status quo with a full ex post true up of any deviation from allowances and expenditure.

Setting up front allowances

3.22. We received little by way of comment on whether we should set the upfront allowance with reference to benchmarking of either pension costs or total employment costs. We assume that this is because, as respondents prefer to retain the status quo of full ex post adjustment, the issue of how ex ante allowances are determined is not so important providing it is reasonable and does not leave them with a large funding shortfall until the next review.

3.23. In considering this issue, we have referred to our first principle which states, "*Consumers should not be expected to pay the excess costs of providing benefits that are out of line with private sector practice, nor for excess costs avoidable by efficient management action. We will, if appropriate, benchmark total employment costs, to ensure companies have correct incentives to manage their costs, including pension costs, efficiently*." And our aim, which is to ensure that our arrangements lead to similar incentives on NWOs as other companies and consider it is appropriate to provide some form of incentivisation to encourage effective management of pension costs. It is therefore within the existing principles to use benchmarking to set ex ante allowances.

3.24. Our principle does not consider benchmarking pension costs alone. This is because in determining the ongoing funding costs for a pension scheme, the actuaries will take into account scheme specific circumstances. As noted in the GAD report, employer contribution rates vary between 20 to 39 per cent. These variations depend in part on the composition of the scheme membership and are very sensitive to the average age of active members, as well as longevity assumptions, differing benefits and differences in valuation assumptions. As there are many factors determining ongoing funding costs, it is unlikely to provide an equitable benchmark for setting ex ante allowances, nor in measuring an incentivised ex post adjustment.

3.25. We have received representations during the course of our review that we should not dictate the pension arrangements that companies offer. We acknowledge those concerns and reiterate that we do not attempt to control the pensions arrangements that management should offer. Rather we aim to put in place incentives so that management can manage their costs effectively. One of the advantages of benchmarking total employment costs (including pensions) is that it provides NWOs with flexibility over their employment package. NWOs operate in a competitive environment for skilled labour and it is the marketplace that should determine the appropriate package. We also considered setting ex ante allowance by reference to expected contribution rates and concluded that it does not incentivise NWOs to manage their pension costs as part of total employment or total costs effectively. We think it is appropriate that NWOs have effective incentives on all costs.

3.26. We think that benchmarking (of employment costs including pensions) is the appropriate methodology because it compares NWOs overall employment package with its peers and other comparable entities and will inherently take into account current employment market conditions. We are minded to use this approach in all future price controls to set the upfront allowances.

3.27. For DPCR5, we are unable to use benchmarking of total employment costs, as we have not undertaken the necessary data collection and analysis. We are minded to for DPCR5 only, to allow DNO's forecast costs subject to any reductions through our normal review processes.

Sharing factors

3.28. We set out two options for incentivisation. One option was to include ongoing pension costs within the existing Information Quality Incentive (IQI) regime, so that pension costs are subsumed within total costs. The alternative was to develop a lower rate, on the assumption that NWOs have less control or influence over these costs because of legislation.

3.29. In general respondents preferred the status quo with no incentivisation and provided no comments on the mechanics for incentivising these costs. NWOs consider they are effectively incentivised, especially where the regulated business is only a part, sometimes a minor part, of their company pension scheme. Consumers on the other hand tended to consider that more could be done and one respondent suggested that pension costs should be treated like any other cost.

3.30. We do not consider that it is appropriate for there to be a full correction for any differences between the actual cash funding compared to the set allowances. This is a pass through and does not incentivise NWOs to manage their pension costs effectively.

3.31. We think there is merit in including pension costs within the overall IQI mechanism as it is a simple and effective mechanism and avoids the need to develop a separate incentive mechanism or incentive rate. It also moves the emphasis away from pension costs and onto the management of total costs. We do not think that the alternative of developing a separate mechanism with a lower incentive rate is appropriate. NWOs have a wide range of costs and in all cases there will be parts that have restrictions on the ability of management to make changes. Ongoing pension costs are no different in that regard. The incentive arrangements are in place to ensure that management take every opportunity to manage their costs efficiently and to act as a restraint on any costs increases. The fact that some arrangements are more difficult to manage is not sufficient reason to exclude them from an incentive mechanism. We are also concerned that a lower sharing rate could weaken the incentive to control costs.

3.32. We think that for all future reviews (excluding DPCR5) it is appropriate that ongoing pension costs (defined benefit and defined contribution) should be part of the overall IQI incentive package.

3.33. For DPCR5, we have to date not included ongoing pension costs within the benchmarking analysis and hence the IQI mechanism. The actual IQI incentive rate is a function of the submissions made by NWOs and the costs we have allowed following our detailed cost assessment work. It is not clear that at this stage in the review, that we should include pensions costs within the IQI mechanism.

3.34. However, as we have highlighted we are concerned to ensure that there are effective incentives in place to ensure that pension costs do not grow unnecessarily and become a problem in the future. We therefore think that we should put in place a specific incentive mechanism for DPCR5.

3.35. Our view is that we should allow DNOs to share in any reduction or increase in costs (including any new deficit created) at a rate of 50 per cent. An alternative would be to set the sharing factor at the same rate that each DNO faces for all costs in DPCR5 that pass through the IQI mechanism.

3.36. We welcome any views on whether the 50:50 sharing rate within DPCR5 is reasonable and proportionate or whether we should apply the IQI sharing rates to the ongoing pension costs.

Deficit - repair periods for upfront allowances

3.37. In July we considered four different approaches we could take to deficit repair periods for setting upfront allowances as follows:

- actual deficit repair period of company scheme,
- the average deficit repair period of all schemes,
- notional period determined by Ofgem, e.g. 10 years, or
- remaining active service lives of active scheme members.

3.38. In considering this issue, we have taken account of respondents' views, current Ofgem practice, the current position of DNOs and statements made by the TPR.

Respondent's views and previous regulatory approach

3.39. There was some support for extending notional repair periods in determining upfront allowances (with one strongly in favour, eight cautiously in favour, five with no view and six opposed) although there was also some support for using actual deficit repair periods.

3.40. In DPCR4, we used remaining active service lives as the basis for setting allowances. At that point all but one DNO had 13 years as the remaining active service life. In TPCR4, we used a 10-year period, which again was the same as the actual repair period. In GDPCR we again used 10 years, although at that time the repair period for NGUK, i.e. the gas scheme, was much shorter at 2.5 years following a valuation at 31 March 2007.

Materiality

3.41. For the October update we have used the forecast periods provided by the DNOs which have a mix of repair periods of between 6-11 years with an average of nine years. The table below shows that there is a very material affect on costs in the DPCR5 period of applying different funding periods. The cost to customers in the DPCR5 period would be £600m higher if we applied the forecast periods provided by the companies rather than a notional repair period of 15 years. This would increase the average X by 0.5 per cent.

Table 3.2: Affect of applying different funding periods

DPCR5	Position at October update	Options		
Deficit repair period (years)	DNOs own period	10	12	15
Total funding requirement	£1.5bn	£1.4bn	£1.1bn	£0.9bn

3.42. We have to consider the ability of consumers to fund DNO pension costs. As highlighted earlier we currently estimate that the average X over the DPCR5 period will need to rise by about 4.7 per cent per annum, in part due to pension repair costs amounting to £1.5bn. We also have to be mindful of the changes taking place in the pension environment generally with many consumers facing a reduction in their personal pension provision and changes being proposed to state retirement ages.

3.43. For DPCR5 we think it is appropriate that we determine a notional recovery period that takes account of these points. A notional period of 15 years is reasonable to be broadly consistent with recent reviews, to reflect uncertainty created by current market conditions, the pressures on consumers created by rising energy bills, rising network charges through DPCR5 and the state of the economy more generally. It would also reduce charges to consumers by approximately £550 million in the DPCR5 period compared to the values in the October update.

3.44. We have rejected the option of using the remaining active services lives, as this was the basis used when the minimum funding requirement basis applied. That basis was superseded by scheme specific funding following the introduction of the Pension Act 2004 and guidance issued by TPR.

3.45. We have also taken into consideration that 13 out the 14 DNOs are currently, or will in the next year, have new recovery plans agreed and given the significant increase in deficits in recent years there is no guarantee that existing repair periods would be regarded as appropriate by trustees and company. We note in particular that the most recent repair period agreed by a DNO was for eleven years. This is similar to the repair periods used in the last three reviews. It is for trustees and scheme sponsors to agree on a deficit recovery plan taking all factors into account and these may vary from the period over which we set allowances. There is no requirement for there to be a match between the repair period set by scheme trustees and the funding of this in the price control as was the case with GDPCR. Our view is that any period has to be affordable by consumers and licensees.

Role of the Pensions Regulator regarding deficit recovery periods

3.46. We acknowledge that TPR has a risk-based approach to all recovery plans submitted to it, which are passed through a number of filters to determine which plans most likely require further consideration. There are three triggers that will filter a recovery plan for review by TPR:

- The period of the plan is longer than 10 years; and/or
- The plan is excessively back-end loaded; and/or
- The investment return assumption over the life of the plan appears to be in-appropriate.

3.47. If we set a notional recovery period that would normally trigger a review and this period is subsequently adopted by schemes, TPR may review the plan. In our discussion with TPR, they have not expressed a view as to what may be an appropriate period for NWOs. They will take into account the strength of the employer's covenant, which we consider to be very strong given that existing deficits will be funded. TPR have considered recovery plans ranging in length from 1 year to over 20 years (for example Post Office has a 17 year recovery plan) to be appropriate given the circumstances of the specific schemes involved[10].

3.48. As noted in chapter 2, TPR published *Scheme funding and the employer covenant*[11] which suggested alternative approaches to recovery plans other than extending the duration of scheme funding. These include, where employers are cash constrained to back-end load the funding, which could include provision to accelerate funding if the employer's financial position improved. Another alternative was a variety of contingent assets that could be secured, guarantees from related or third parties, security over assets or assets in escrow accounts.

3.49. These alternative arrangements have attractions in reducing the short-term funding requirements and may be considered by trustees and licensees. However, we have not chosen to apply back end loading preferring instead to assume a reasonably long notional recovery period.

3.50. Taking all the above into consideration and recognising that in current circumstances deficits are at a high level compared to recent years we consider that it is appropriate to use a notional repair period at the top end of our range and believe that a minimum of 15 years is appropriate.

3.51. For future reviews, we will start our considerations at a similar repair period but recognise that we need to consider the factors pertaining at the time.

[10] http://www.tpr.gov.uk/pdf/EmployerCovenantStatementJune2009.pdf
[11] http://www.tpr.gov.uk/pdf/EmployerCovenantStatementJune2009.pdf

Deficits - Appropriate valuation

3.52. All options in our July 2009 consultation involved funding the deficits as at the end of each of the current price controls. In the case of DPCR5, this means funding the deficit as at 31 March 2010. We set out four options for establishing which valuation should be used to establish the pension cost element of the revenue allowances. The four options on valuations were:

- Each company's last triennial valuation,
- Each company's latest interim valuation update,
- NWOs projections of subsequent movements; and
- Conformed valuations.

3.53. The strengths and weakness of the first three options can be found on page 37 of the second consultation[12].

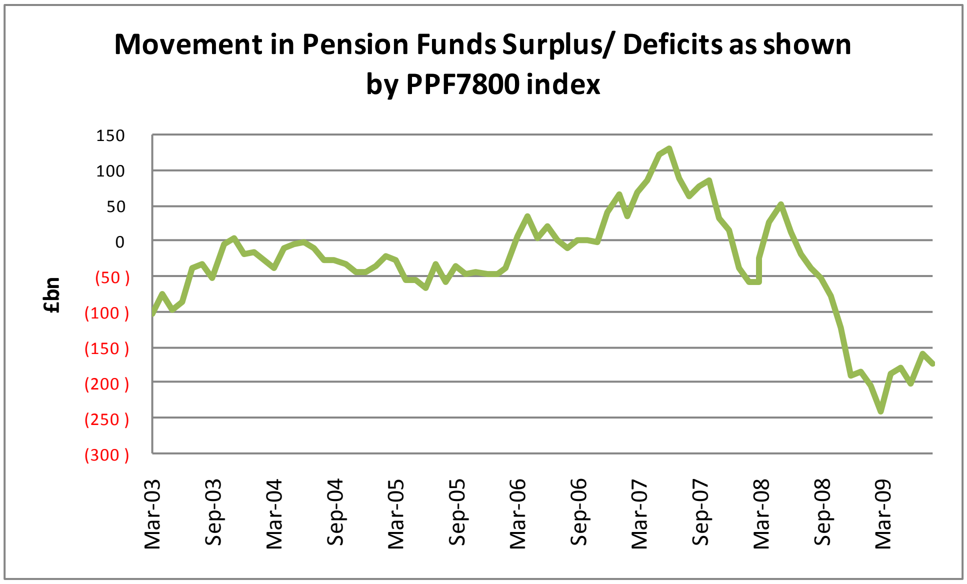
3.54. In considering the appropriate valuation, we have taken into account a number of factors including responses to the consultation and at the last seminar, recent volatile market movements and resulting large deficits and the timing of DNO valuations.

3.55. We had a range of responses on this issue with six respondents favouring the use of the latest information available, two the last interim update and three the latest full triennial valuation. One respondent believed that like all other cost lines in the price control framework, pension costs should be forward looking and as all schemes are now required to have funding updates carried out annually, the latest review should be used based on the latest market information practically available. There was therefore strong support for the use of the latest information available.

3.56. In recent years, market movements have been exceptional with equity markets falling by 37 per cent over 6 months to March 2009 and typical gilt yields falling by 50 per cent over the same period. This has had a significant impact on the deficits of pension schemes. The diagram below shows the movement of deficits over the last six years based on the PPF7800 index.

[12] Price Control Pension Principles second consultation document (96/09) http://www.ofgem.gov.uk/Networks/Documents1/Price per cent20control per cent20pension per cent20principles per cent20second per cent20FINAL.pdf

Table 3.3: Movement in PPF7800 Index



3.57. This shows that deficits on schemes in the PPF7800 index have grown by £200bn since the last round of DNO triennial valuations in 2007 and that since March 2009 there has been some recovery.

3.58. The recent movements in the deficit position of DB schemes highlights the importance of the timing of valuations relative to the time that the ex ante price controls are being set. In DPCR4, the latest full valuation was available and appropriate to be used in setting price control revenues. For DPCR5, ten DNOs have their next full valuations falling due as at 31 March 2010, three have valuations at 31 March 2009 (which have yet to be concluded) and one was at 31 March 2008. In light of the volatile market conditions of recent years, we think that the latest update would give a more representative value of the likely deficit as at 31 March 2009. Using the latest valuation would be fully compliant with principle 4 "Licensees are required to provide up-to-date actuarial calculations".

3.59. We therefore think that for DPCR5 it would be appropriate to use as up to date figure as possible or an average of recent values. For DPCR5, the latest information available will be the updated valuation data as at 30 September 2009 that we have requested.

3.60. For future reviews, the appropriate valuation will depend on the timing of full valuations, and the state of the market at the time when we set the appropriate price control revenues.

3.61. As we are funding the deficit as at the end of current price controls, it is appropriate to take the deficit from formal valuations at 31 March 2010 and to true up in DPCR6. It is our intention to take a similar approach in TPCR5 and GDPCR2 subject to the timing of their latest full valuations and market conditions.

3.62. The fourth option set out above was to use a conformed valuation. Respondents were opposed to using conformed valuations. The main objections were that they could lead to 'arbitrary' results, with difficulties in getting a balanced set of assumptions (particularly ones that bear some relevance to the costs being incurred by companies); do not allow for scheme specific circumstances and have a poor track record. Some suggested that conformed valuations were inconsistent with the principles of scheme specific funding enshrined in legislation and that if conformed valuations were appropriate, TPR would have mandated a conformed approach. Another suggested that it might have the perverse result of incentivising companies to take more investment risk with the scheme, with the downside borne by future customers.

3.63. Further reasons against were that they may have the affect of creating a floor level for assumptions leading to a one-way ratcheting-up of costs, or there use could lead to significant over/under funding and therefore costs not being borne by the right generation of customers. A view was expressed that they were thought to be more costly and complex adding to both scheme and consumers' costs.

3.64. We have considered respondents' views and agree that there are sufficient issues surrounding conformed valuations to make them unattractive as a tool in determining allowances at the moment.

Deficits - ex post incentivisation

3.65. Respondents have not commented specifically on the potential incentivisation options we set out for existing liabilities either because (a) they consider there is adequate incentivisation already, or (b) they considered that the option had not been developed in sufficient detail. We have given this matter considerable thought, looking at a number of different approaches we could take to the treatment of deficit costs. Below we set out the thinking that has led us to the minded to position that there should be no automatic mechanism to incentivise pension deficit costs, but that there should be a trigger in place to signal the need for a further review of a company's costs before making any ex post adjustments at the end of a price control period.

Consideration of incentivisation of actual contributions

3.66. We have given further consideration to the option set out in the second consultation document of applying a modest 2-10 per cent sharing of differences between actual and allowed contributions. We have concluded that using the difference between allowed and actual contributions has attractions as a simple, clear and transparent mechanism. However, it also has drawbacks in that it is only a timing mechanism and does not fundamentally affect the level of the deficit.

3.67. For example, it may be possible for DNOs to defer making contributions for a short period and then make accelerated payments thereafter. This could enable the DNO to gain a share of reduced payments (which could be sizeable amounts) without affecting the deficit that would ultimately need to be funded by consumers and could in fact make the deficit even larger.

Consideration of incentivisation around changes in the value of the deficit

3.68. We have also considered an automatic mechanism that sets incentives around changes in the value of the deficit over the price control period on the grounds that the closing value of the deficit is the cost to be ultimately funded by consumers, unless economic factors or other effects reduce the deficit over time. However, as the value of the deficit is significantly affected by market movements, this could mean that companies would gain or lose depending on how the market was performing, rather than how well they had managed their deficits.

3.69. In order to overcome this deficiency we considered the use of an independent index to remove the general effects of exposure to market movements and other factors. We considered a number of indices and concluded that the PPF7800 index was the best alternative in that this was independently produced on a monthly basis, covered a large number of schemes (approximately 7,400) and would also pick up all factors affecting general deficit movements, for example changes in longevity assumptions. We recognise that many of the schemes within the index are very small. However, we believe that it is important that the index has as wide a coverage as possible and the index will be dominated (in value terms) by the large schemes such as those sponsored by the NWOs.

3.70. We think in practice it would be possible to reward or penalise companies depending on how the value of their deficit moved against the index, perhaps with the use of dead-bands to allow for scheme specific factors. However, we have rejected this approach because it introduces a high degree of complexity into the pension cost arrangements. We also recognise that there may be valid reasons for the movement in the deficit in a particular scheme to vary from the average of all schemes. This is so, even with a dead-band in place. This could have the perverse impact of encouraging companies to track the index rather than manage their own funds appropriately. We therefore consider that an automatic incentive mechanism such as this is not an appropriate way forward, without further refinement, as it could unfairly penalise or unduly reward some NWOs.

Consideration of review trigger mechanism

3.71. An alternative option is to use the same general approach to highlight schemes where the movement in the deficit (using the movement in the underlying assets and liabilities) seemed to be out of line with the general market as indicated by the PPF7800 index. Where the movement in the deficit of an NWO's scheme was highlighted as being out of line with the general market movement we would investigate the movement in the deficit with the onus on the NWO to demonstrate the deficit had been effectively and efficiently managed on behalf of consumers. Where a scheme outperforms the index then there would be no review but the compnay would be able to make a case to retain any efficiency gains. If the actual spend is less than the allowance, then this will be clawed back in accordance with principle 5 "Under-funding/Over-funding" for the benefit of consumers.

3.72. This has the advantage over the automatic mechanism of allowing NWOs to explain why it was appropriate for their scheme to have a different movement in the deficit to the movement in deficits generally while providing more clarity as to how we will test that a NWO meets the economic and efficient test.

3.73. The table below provides an example of how the mechanism would operate.

Table 3.4: Mechanism for testing against PPF7800 index

PPF Index						
	Start	Finish	Movement			
Assets	900	1080	20.0% (a)			
Liabilities	1100	1155	5.0% (b)			
Deficit	(200)	(75)	62.5%			
Network Operator						
	Start	Finish	Movement		Projected	
Assets	150	175	16.7%	underperforms	180	Start x (1+a)
Liabilities	200	215	7.5%	underperforms	210	Start x (1+b)
Deficit	(50)	(40)	20.0%		(30)	Difference
	(1)	(2)			(3)	
		(4) Expected improvement			20	(1) - (3)
		Actual improvement			10	(1) - (2)
		(5) Actual improvement plus 5% of allowed band			11	
			Underperformance outside		9	(4) - (5)
			Review triggered			

3.74. We think this review trigger mechanism will provide a useful incentive on management to ensure as far as they are able, and as far as this is consistent with the long term funding strategy, that the schemes of which they are a sponsor do not have deficits that increase at a faster rate than for schemes in general or do not decrease at a slower rate than the average of other schemes.

3.75. We also recognise that Schemes will and should make their own investment and other decisions that are appropriate to their own individual circumstances and the advantage of this approach is that it allows NWOs to be able to explain the reasons for any divergence from industry norms.

4. Application issues

Chapter Summary
This chapter sets out our minded to position on a number of application issues on which we have consulted, together with the treatment of bulk transfers in and any subsequent movement in the related deficit. We also clarify the tax treatment of pension costs in our price control revenue model.

Question 1: Views are invited on our minded to position on the application issues and whether these provide the necessary clarity.

Question 2: Views are invited on the logic of the methodology for rolling forward unfunded ERDCs in principle 6.

Question 3: Views are invited on whether ring-fencing movement in deficits related to bulk transfers in is appropriate in all circumstances.

Introduction

4.1. We have consulted on a number of application issues which we, and respondents agreed, required clarification. These relate to the treatment of:

- Pension administration costs,
- Pension Protection Fund levies,
- Stranded surpluses,
- Buy-ins and buy-outs, and
- Unexpected lump sum deficit payments.

4.2. All of these issues will inform our assessment of ex ante allowances, where the facts are known and subsequently the ex post adjustments.

4.3. We have listened carefully to the views expressed in the consultation responses. We set out our minded to position on these issues below.

4.4. We have also reviewed the treatment of bulk transfers into a scheme. At issue is whether any subsequent movement in the related deficit should be ring-fenced. In assessing the ex post adjustment for DPCR4, we have also addressed the treatment of movements in early retirement deficiency contributions (ERDCs), and when it is appropriate to revise the regulatory fraction. We set out our minded to position on this in our 5 October update letter[13] issued as part of the DPCR5. process. For

[13] Electricity Distribution Price Control Review - October update covering letter http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=323&refer=Networks/ElecDist/PriceCntrls/DPCR5

completeness we have incorporated our minded to position on these issues under the relevant principles in appendix 3.

Pension administration costs under Principle 1[14]

4.5. Respondents' views are that trustees remain sufficiently incentivised already to manage their administration costs efficiently. We agree that it is not necessarily appropriate to benchmark pension administration costs. There are limitations in our ability to benchmark these costs in part because we do not have full access to the data[15], and also because administration costs will vary depending on, for example, a scheme's investment strategy - many investment fees are performance related. We may seek to collect this data for future reviews as part of the annual price control cost reporting process.

4.6. However, we are minded to conform the treatment of pension administration costs paid directly by licensees compared to those funded through increased employer contributions to the scheme in setting ex ante allowances. In future, we are minded to treat both as pension costs. We will retain the option to incentivise these costs separately but given their relative immateriality, we are unlikely to do so unless there are signs that NWOs are failing to exert control over these costs.

Pension Protection Fund Levy under Principle 1

4.7. There are a number of elements to the Pension Protection Fund Levy, the largest is risk based, i.e. on the risk of insolvency determined based on the failure score, risk indicator or equivalent for each scheme's sponsoring employer by Dun & Bradstreet to the PPF. This has been seen to be the highest cost element and depends on the requirements of the PPF. As such, its magnitude is partly outside the control of sponsors and trustees.

4.8. We are minded to continue monitoring the actions taken to mitigate the cost of the risk based element of the levy where this can affect the levels, e.g. an NWO's Dun & Bradstreet Failure Scores (used to measure a company's insolvency risk) where a low score contributes to higher rate of the levy. We reserve the option to make adjustments on a case-by-case basis where the charge[16] appears excessive compared to its peers or there is evidence to indicate inefficiency in managing this cost.

4.9. At DPCR5, we have capped the ex ante allowance related to the levy due to significant variations in the level of forecast levies.

[14] Efficient and Economic Employment and Pension Costs
[15] The data is property of the pension scheme and not the sponsors
[16] Or in the case of forecasts used to inform the setting of revenue allowances.

Stranded surplus under Principle 1

4.10. In the event that a surplus arises (i.e. assets exceed the full buy-out cost of accrued liabilities), trustees have the power to decide whether it is in the interests of scheme members to repay the surplus to the employer in accordance with the scheme rules and other legal requirements. Trustees have obligations to protect scheme members, and are likely to use any surplus in de-risking their investment strategy. If this was the case consumers may not benefit, although they, together with scheme members and sponsors, would have contributed to the surplus.

4.11. It is our intention to monitor the schemes' position and we would expect symmetry in treatment with funding of deficits to share the benefit across members and consumers. As such, if a scheme were in surplus for a given period we would consider our options when setting allowances such that consumers would benefit and the shareholders would cover the cost if contribution levels were not adjusted. We do not consider that reducing risk is always efficient if it leads to higher funding and deficits. Each instance would be reviewed on case-by-case basis. In assessing the trigger, we will look at scheme assets and liabilities separately, thus an increase in the value of scheme assets above the market level will trigger a review, particularly if a scheme has moved into surplus position.

Buy-ins/buy-outs of pension schemes under Principles 1, 2 & 5

4.12. The treatment of buy-ins to and buy outs of the pension scheme currently fall within the scope of principles 1, 2 and 5 (as set out in Appendix 3). Respondents did not specifically address whether a new principle was required, only seeking clarification on how such de-risking would be funded to facilitate efficient management of the schemes and to remove uncertainty on their treatment. Some considered that we should not fetter trustees' decisions or rights to de-risk such as buy-outs / buy-ins; and others that we should consider and clarify what efficiency criteria we might apply when assessing if de-risking costs may be recovered.

4.13. We consider that it is difficult to be prescriptive as to how the de-risking costs should be spread between different generations of consumers. An equitable option is to spread these costs over the same period that we use in setting ex ante allowances. We are minded not set to out a new principle and will deal with these, if and when they occur, within the existing principles on a case-by-case basis.

Regulatory Fraction under Principle 2[17]

4.14. We review each NWO's regulatory fraction when we set ex ante allowances and we check for changes to this fraction when assessing the ex post adjustment, when there have been structural changes to a scheme, and at each full valuation within a price control period. At these points we will also review and adjust for movements, including cash funding by sponsors to the previously unfunded ERDCs.

4.15. Structural changes may occur when:

- schemes merge or demerge,
- members are transferred in or out in bulk,
- there is a change of ultimate controller, and
- there is a buy-in/buy-out of any part of the scheme membership.

4.16. We expect NWOs to maintain appropriate records to enable this assessment. In the absence of detailed records, we will apply our own judgement. We will revise the allowed proportion and apply it within a price control period for computing the ex post adjustments and updating RAV where deficits are part of additions to RAV.

4.17. We will review each occurrence on its merits and would expect companies to approach us at an early stage to discuss the possible impact on their regulatory fractions. We will not specifically require an actuarial assessment and valuation at each trigger point above to determine the revised allowed proportion, as we recognise that it is not necessarily cost effective for NWOs to have an annual actuarial assessment of this split. If one exists, we will use it to inform the assessment.

4.18. The regulatory fraction will be reviewed at each subsequent price control using the basis in the previous control as a starting point and allowing for structural changes as set out above. For example, in DPCR5 this would be the 80/20 split between regulated /non-regulated activities and businesses adopted for most companies at DPCR4 - see appendices 3 and 4.

Unexpected lump sum deficit payments under principle 5[18]

4.19. These tend to occur in instances of change of corporate control. Whilst we can understand the trustees taking the opportunity to repair the deficit faster, it is not clear why consumers should pay for an accelerated profile.

[17] Attributable Regulated Fraction Only
[18] Under Funding / Over Funding

4.20. Our current application of the principles is to review the payment of the lump sum compared to what the position would have been if the deficit had been spread over a number of years. This is to ensure that consumers have either positively benefited from, or have not been disadvantaged by the accelerated funding. Where a company cannot satisfy us that the accelerated payment has been in the interests of customers (as opposed to shareholders or scheme members), we will treat the payment as having been made over the period according to the original deficit recovery plan.

Bulk transfers in under Principles 1, 2 & 5

4.21. During a price control period there may be bulk transfers of members in or out of a DB scheme through corporate activity. These transfers are usually only accepted when the transfer value finances the deficit, if any, of the transferees. TPR guidance states: "There is no statutory obligation for a trust-based scheme to accept transfers-in and provide benefits in exchange. Some schemes do offer defined benefit transfer credits, typically in the form of 'added years' counting for benefits on the scheme's normal formula. Other schemes offer money purchase benefits in exchange for transfers, in which case no issues arise as to assumptions for determining benefits"; and also, "A transfer credit should not be expected to require additional funding from the employer in the long term unless agreed by the employer in advance."

4.22. Whilst transfers in may be accepted and some may be of protected persons who may or may not be considered part of the regulated activities, it is considered that in order to control future deficits that shareholders, not consumers should fund any increase related to the transferees at future price controls. Views are invited on whether ring-fencing movement in deficits related to bulk transfers in is appropriate in all circumstances.

Monitoring Pension costs and pension scheme activity

4.23. We intend to collect from NWOs data (on an annual basis) on both their actual pension costs and scheme data similar to that collected in the December 2008 DB Scheme questionnaire. This will be through the annual price control cost reporting and we will publish such data as is agreed with the NWOs in our annual compliance reports. For the DNOs, the licence conditions are currently being reviewed in consultation with them, as are the future reporting requirements and structure of future annual reports. Those for TOs and GDNs will be dealt with either at, or as part of, the annual review of the regulatory reporting rules, and/or at future price control reviews.

Tax treatment of pension costs

4.24. Tax legislation relating to the deductibility of and the treatment of ongoing pension costs and deficits have changed since the last three controls were set. We consider that it is appropriate to set out our position on the tax treatment of deficits in modelling revenues. The basic assumption applied at all price controls is that the distribution and /or transmission business is a standalone taxable entity and all costs should be modelled as incurred in the entity and that they do not lose their identity as pension costs, if they are incurred in a related party or the regulated entity.

4.25. We model the cash costs of pensions as deductible in accordance with legislation at 100 per cent, subject to the recently introduced irregular payment rules, which spread the relief over more than one year for significant increases. We will follow tax legislation extant at the relevant price control. Ex post adjustments will be made net at the applicable rate of corporation tax for each year to avoid double-counting the tax effect on the revenues.

Appendices

Index

Appendix 1 - Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below. Responses should be received by 13 November 2009 and should be sent to:

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1.2. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.3. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

CHAPTER: Three

Question 1: Do you agree that applying benchmarking to all employment costs (including ongoing pension costs) appropriately incentivises NWOs to manage those costs efficiently?

Question 2: Views are invited on whether our proposed treatment for DPCR5 is appropriate?

Question 3: What do you think would be an appropriate sharing factor to apply to ongoing pension costs in DPCR5?

Question 4: Do you agree with the proposal to introduce a notional deficit repair period for all network companies?

Question 5: Views are invited on whether 15 years is the appropriate notional funding period to protect consumers, or whether we should set 10 years as the minimum, or use a figure between these two numbers.

Question 6: Views are invited on whether using the latest updated, rather than the last full, valuation is the most appropriate given the recent volatile market conditions.

Question 7: Do you agree with our proposal to introduce a trigger for a review of the efficiency of companies' pension costs at the end of each price control period?

Question 8: Views are invited as to whether the PPF7800 index is an appropriate index to use as the trigger mechanism for a review of deficit movement.

Question 9: Do you think our minded to position overall achieves an appropriate balance between our duties to protect consumers and allow NWOs appropriate funding of pension deficits?

CHAPTER: Four

Question 1: Views are invited on our minded to position on the application issues and whether these provide the necessary clarity.

Question 2: Views are invited on the logic of the methodology for rolling forward unfunded ERDCs in principle 6.

Question 3: Views are invited on whether ring-fencing movement in deficits related to bulk transfers in is appropriate in all circumstances.

Appendix 2 – Summary of responses to second consultation

1.1. A brief summary of the consultation responses to the July 2009 consultation is provided below. As with the first consultation, the view of NWOs and the unions remains unchanged from that at that consultation, which is to retain the status quo. NWOs consider that they are adequately incentivised by the existing arrangements, and cite the Government Actuary's Department report as evidence that their pension costs are being managed efficiently. Conversely, customers argue that NWOs can do more to reduce pension costs and support some form of incentivisation.

Chapter One

Question 1: Should we continue with the current approach, which puts the onus on us to review information submitted by the NWOs to make judgements of efficiency or otherwise, or should we introduce some incentives on NWOs to manage existing and future pension liabilities?
Most respondents were in favour of retaining the status quo. Customers favour some form of incentivisation although only one suggestion is made, to treat pension costs the same as other operating costs. A major customer and Customer Focus believe that it is important that there is some incentivisation on network companies and some sharing of the costs between consumers and shareholders to meet the stated aims of the review. Centrica in particular have suggested strongly that costs should be benchmarked and incentivised like any other cost.

Chapter Three

Question 1: Views are invited on the options for managing pension costs and whether retaining the status quo is, or is not, an effective incentive on management to manage pension costs?
Most respondents consider that the current regime has adequate incentivisation and cite the GAD report as evidence that pension costs are being efficiently managed. A major customer suggests that further incentivisation is required since there is little evidence to suggest that NWOs have taken significant steps to manage costs efficiently. They also interpret the findings of the GAD report as suggesting that NWOs manage their pension funds less efficiently in terms of benefit levels and investment strategy than they might.

Question 2: Views are invited on the options set out for setting ex ante allowances and whether this set of options provides a good balance between allowing the NWOs funding for existing commitments, whilst moving towards a more incentivised approach for future commitments?
There is a variety of views on this matter. The consensus is opposed to conformed valuations but there is no clear agreement on the setting of ex ante allowances. One respondent has suggested that setting an overall allowance for employee remuneration would allow NWOs flexibility to choose between wages and pensions as they see fit.

Question 3: As an alternative to specifically adopting one or all of the options set out, should we introduce a form of menu regulation where NWOs could select one of the options? NWOs choosing a de-risked approach would receive a lower allowed return than those that did not.
Menu regulation is not favoured and many respondents dispute the logic in linking cost of capital to the regulatory treatment of pension costs. The NWOs mostly make the point that they have limited control of past liability costs and use this to justify retention of the status quo.

Chapter Four
Question 1: We invite views on whether it is appropriate for consumers to fund any additional costs arising from a buy-out or buy-in and, if so, over what period should the costs be spread so as to share the burden between current and future generations of consumers that may benefit?
NWOs mostly agree that customers should bear the cost of buy-outs/buy-ins though there is less agreement regarding the period over which these costs would be recognised. Most respondents agree that buy-outs or buy-ins are unlikely in the near future**.**

Question 2: We invite views on which is the most appropriate valuation to use in setting ex ante allowances and whether this should depend on employers' actual funding being revised to match that based on that valuation?
The consensus is that conformed valuations are not acceptable and that the latest valuation should be used. There are differences between the respondents regarding the details of the valuation methodology though most suggest that the valuation be as recent as possible and use forward looking assumptions.

Other comments made by respondents
Several respondents suggested that there was insufficient time to consider any changes that would impact the DPCR5 price review.

Several respondents commented that they thought PPF levies need not be given a separate allowance, as it would not be efficient to do so.

There were other comments made regarding the extent to which NWOs can influence their pension costs. Both sides of the argument were given by different respondents.

Some respondents consider that regardless of any new approach to treating pension costs, and if Ofgem chooses to retain the current approach, a prerequisite is for companies to be required to publish annually the type of information that we requested in the consultation.

Seminar on 8 September 2009

This seminar enabled stakeholders to discuss specific consultation topics in five working groups and to feedback at a question and answer session. The seminar was well attended. In general, it reflected broad support for continuation with the status quo. There was little appetite for incentivisation, although there was some recognition of the merit in Ofgem imposing a standard notional deficit repair period on the NWOs. One suggestion at the seminar was to protect NWO and consumers from significant variances in the timing of cashflows from allowances and to match cash funding costs, through re-openers at each subsequent full valuation of schemes, rather than waiting until the next control for the ex post true up.

Appendix 3 - Pension Principles

1.1. We set out below the updated application of the pension principles based on our minded to position for DPCR5. Some of the previous principles remain valid for the TPCR4 and GDPCR reviews and have not been amended.

1.2. Clarifications introduced are:

- Pension administration costs,
- Pension Protection Fund levies,
- Stranded Surplus,
- Buy-ins and buy-outs,
- Unexpected lump sum deficit payments,
- The treatment of movements in ERDCs, and
- When the regulatory fraction may be revised.

These items are shown in italics in the text to indicate the updated wording from text in the previous consultations.

Defined Benefit schemes

Principle 1 - Efficient and Economic Employment and Pension Costs

Customers of network monopolies should expect to pay the efficient cost of providing a competitive package of pay and other benefits, including pensions, to staff of the regulated business, in line with comparative benchmarks

1.3. Consumers should not be expected to pay the excess costs of providing benefits that are out of line with the wider private sector practice, nor for excess costs avoidable by efficient management action. We will, if appropriate, benchmark total employment costs, to ensure companies have correct incentives to manage their costs, including pension costs, efficiently.

Pension administration costs

1.4. *We will normalise the treatment of pension administration costs paid directly by licensees compared to those funded through increased employer contributions to the scheme in setting allowances. In future, we will treat both as pension costs. We retain the option to incentivise these costs separately but given their relative immateriality, we are unlikely to do so unless there are signs that NWOs are failing to exert control over these costs.*

Pension Protection Fund Levy

1.5. *There are a number of elements to the levy, the largest is risk based. This has been seen to be the highest cost element and is dependent on the requirements of* *the PPF. As such, its magnitude is partly outside the control of sponsors and trustees. We will continue to monitor the actions taken to mitigate the cost of the risk based element of the levy where they can affect the levels, e.g. their Dun & Bradstreet Failure Scores (used to measure a company's insolvency risk) where a low score contributes to higher rate of the levy. We reserve the option to make adjustments on a case-by-case basis where the charge appears excessive compared to peers or there is evidence to indicate inefficiency in managing this cost.*

1.6. *At DPCR5, we have capped the ex ante amount due to significant variations in the level of forecast levies, but will adjust ex post in line with other ongoing pension costs.*

Stranded surplus

1.7. *In the event that a surplus arises (i.e. assets exceed the full buy-out cost of accrued liabilities), it is trustees that have the power to decide whether it is in the interests of scheme members to repay it to the employer in accordance with the scheme rules and other legal requirements. Trustees have obligations to protect scheme members, and are likely to use any surplus in de-risking their investment strategy. If this was the case consumers may not benefit, although they, together with scheme members and sponsors, would have contributed to it.*

1.8. *It is our intention to monitor the schemes' positions and we would expect symmetry in treatment with funding of deficits to share the benefit across members and consumers. As such, if a scheme were in surplus for a given period we would consider our options when setting allowances such that consumers would benefit and the shareholders would cover the cost if contribution levels were not adjusted. We do not consider that reducing risk is always efficient if it leads to higher funding and deficits. Each instance will be reviewed on case-by-case basis.*

Buy-ins / buy-outs of pension schemes

1.9. *These currently fall within the scope of principles 1, 2 and 5. This is to provide clarification on how such de-risking would be funded to facilitate efficient management of the schemes and to remove uncertainty as to the treatment. It is difficult to be prescriptive as to how they should be spread between different generations of consumers. For guidance, an equitable option is to spread these costs over the same period that are used in setting ex ante allowances. We will deal with these, if they occur, applying the existing principles on a case-by-case basis.*

Principle 2 - Attributable Regulated Fraction Only

Liabilities in respect of the provision of pension benefits that do not relate to the regulated business should not be taken into account in assessing the efficient level of costs for which allowance is made in a price control

1.10. It is for shareholders, rather than consumers of the regulated services, to fund liabilities associated with businesses carried on by the wider non-regulated group.

This includes businesses that were formerly carried on by the same ownership group and have been sold, separated and/or ceased to be subject to the main Price Control review. In principle this may include costs related to self-financing excluded services, distributed generation, metering, de minimis activities of the NWO and of unregulated businesses in the same scheme, de minimis or business and excluded services (which are self-financing) in the context of a transportation and distribution price controls. However, in some cases, the costs of such businesses are not readily separable from the regulated business and so they are dealt with on a case-by-case basis.

1.11. At DPCR4, there was a general assumption of a 20 per cent disallowance for non-regulated activities for most licensees. For DPCR5, we will retain this split as a starting point. At TPCR4, only the proportion of ongoing contributions and existing deficit that related to unregulated activities was disallowed. In GDPCR, a small adjustment was made in respect of pensions relating to the metering business.

1.12. *The regulatory fraction determined in setting allowances will be reviewed to assess the ex post adjustment when there have been structural changes to a scheme, at each full valuation within a price control period and for setting ex ante allowances at each price control. We will also review and adjust for movements, including cash funding by sponsors to the previously unfunded ERDCs.*

1.13. *Structural changes may occur when:*

- *schemes merge or demerge,*
- *members are transferred in or out in bulk,*
- *there is a change of ultimate controller, and*
- *there is a buy-in/buy-out of any part of the scheme membership.*

1.14. *We expect NWOs to maintain appropriate records to enable this assessment. In the absence of detailed records, we will apply our own judgement. We will revise the allowed proportion and apply it within a price control period for computing the ex post adjustments and updating RAV where deficits are part of additions to RAV.*

1.15. *We will review each occurrence on its merits and would expect companies to approach us at an early stage to discuss the possible impact on their ex post adjustments. We will not specifically require an actuarial assessment and valuation at each trigger point above to determine the revised allowed proportion, as we recognise that it is not necessarily cost effective for NWOs to have an annual actuarial assessment of this split. If one exists, we will use it to inform the assessment.*

1.16. *The regulatory fraction will be reviewed at each subsequent price control using the basis in the previous control as a starting point and allowing for structural changes as set out above. For example, in DPCR5 this would be the 80/20 split adopted for most companies at DPCR4.*

Principle 3 - Stewardship - Ante / Post Investment

Adjustments may be necessary to ensure that the costs for which allowance is made do not include excess costs arising from a material failure of stewardship

1.17. Any excess costs arising from material failure in the responsibility for taking good care of pension scheme resources so entrusted will be disallowed. Examples might include items such as recklessness, negligence, fraud or breach of fiduciary duty, *though, since the pensions principles were established, the Pensions Act 2004 introduced a requirement that trustees should have knowledge and understanding of the law of trusts and pensions and principles of funding and investment. This should mean it is less likely that we will encounter poor stewardship issues. We will review stewardship and reserve our position to make adjustments to allowances if we observe, for example, any of the following:*

- *poor investment returns over a long period, e.g. greater than a single price control,*
- *whether the scheme investment managers are underperforming against their peers or the market and expectations and their performance has not be reviewed or benchmarked at appropriate intervals,*
- *not matching investment/returns to fund future liabilities as they fall due,*
- *material increase in deficits and need for increasing the funding,*
- *maintaining a higher balance of investments in riskier assets compared to investment returns which do not match future liabilities,*
- *accepting transfers in at under value, and*
- *making transfers out at over value.*

1.18. In determining whether pension costs are reasonable, we may compare the level of funding rate recommended by periodic actuarial valuations to the actual funding rate adopted by the licensee. As long as a funding valuation uses actuarial assumptions which are in line with best practice the costs will be allowed in full, subject to any incentivisation adjustment. This is one indicator of whether there has been a material failure in stewardship. We will also examine investment and administration costs to see whether these are materially out of line with industry figures.

1.19. We recognise that the choice of investment strategy is one for trustees and necessarily involves the exercise of judgement, which, for any particular scheme and at any particular point in time, the trustees are best placed to make. These pension principles make clear that we do not think it is appropriate, given our statutory remit, for us to make judgements about investment strategies. In particular, the success or otherwise of any particular strategy can only be measured in hindsight, whereas trustees must make ex ante choices. Moreover, the strategy, which optimises outcomes over the whole life of a scheme, may produce inferior results over any particular shorter period (and vice versa). Therefore, it would be inappropriate for us to make judgements about investment strategies based on outcomes over the five-year period of a price control.

Principle 4 - Actuarial Valuation / Scheme Specific Funding

Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice

1.20. We expect the level of scheme funding to be assessed on the basis of forward looking assumptions regarding long-run investment returns and other key variables. Licensees are required to provide up-to-date actuarial calculations (including the most recent formal actuarial valuation of the relevant schemes) to support their cost estimates.

1.21. We would not expect substantial differences between companies. However, if in any case there is one or more marked outlier, we will investigate the reasons for this. If these investigations reveal evidence of material differences and these differences have contributed to an increase in funding required we would adjust the recommended funding rate for the purposes of setting the price control.

1.22. *We would expect that where the timing of valuations does not align with price control periods, companies will obtain updated valuations as close as possible to the end of the price control as is practical given the timing of setting the final proposals.*

Principle 5 - Under Funding / Over Funding

In principle, each price control should make allowance for the ex ante cost of providing pension benefits accruing during the period of the control, and similarly for any increase or decrease in the cost of providing benefits accrued in earlier periods resulting from changes in the ex ante assumptions on which these were estimated on a case-by-case basis

1.23. Typically, actuarial valuations of pension funds are carried out triennially. In contrast, price controls are typically set for periods of five years. Accordingly, it is possible that funding rates will change during the period of a price control. *In practice with scheme-specific funding and the Pension Act requirement for annual valuations it is possible that individual or scheme specific events may bring forward valuation dates. There have been two cases in DPCR4.*

1.24. *In our minded to position for DPCR5, we have set a trigger mechanism for clarifying when we would either true up to actual cash costs or subject them to a review to assess the quantum of costs that we would true up ex post. In principle we will apply the following guidelines:*

1. *We will log up the cumulative effect and pass the impact through to consumers when setting the price control at the subsequent review subject to determining that such costs comply with principle one being both economic and efficient and subject to the incentive mechanism applicable at each control.*

2. *In assessing the quantum, adjustments may be made only in respect of ex ante assumptions, which are outside the control of the sponsor, e.g. mortality assumption changes, membership, market movements and legislation.*

3. *Subject to any applicable incentive mechanism, we will reflect differences (if any) between the allowances made in setting previous price controls and the actual employer contributions made to pension funds in the same periods.*

4. *To the extent that actual contributions in any period fall short of or exceed the assumed contribution, the amount of the shortfall or excess would need to be rolled forward to the date of the actuarial valuation on which the future price control allowance is based. We consider that for under-funding of deficit contributions this should be done by assuming a total return in line with the scheme specific ex post returns typically earned by the funds in the relevant period(s). As over-funding reduces the risk for consumers, it will be rolled forward using the post tax cost of debt assumption contained within the price control. This is also the case for ex ante and ex post assumption charges, both of which are outside the company's control.*

5. *Where there is a material difference between the assumptions proposed by different actuaries and agreed by the boards of regulated networks, and therefore the costs paid by different groups of consumers vary materially, we will review on a case-by-case basis to ensure that the interests of consumers are not being compromised.*

6. *If we think that the level of funding has the impact of penalising current consumers, albeit that this may be for the benefit of future consumers, we may choose to defer some of the funding of the proposed contributions until future price control reviews. This is to ensure that the overall interests of consumers are met.*

7. *Subject to any applicable incentive mechanism, we retain the right to disallow recovery of any increase in pension costs, which has the effect (intentional or otherwise) of reducing other operating costs on a symmetric basis, and therefore where the application of the over-funding principle would not be consistent with Principle 2 (Attributable Regulated Fraction).*

8. *Equally, we would not recover from companies reductions in cash pension contributions which can be shown to be as a direct result of increased efficiency in employment management costs, for example as a result of outsourcing or moving staff from a current defined benefit to a lower-cost defined benefit or a defined contribution scheme.*

9. *Subject to any applicable incentive mechanism, the difference between the ex ante allowances for pension administration costs and PPF levy and the actual cash funding costs will be adjusted at the next price control subject to their being demonstrated to be economic and efficient, e.g. that steps have been taken to mitigate the risk based element of the PPF levy.*

10. *As noted under principle two, we will apply a revised regulatory fraction where there have been structural changes to a scheme in the price control period on a case-by-case basis. The element of the fraction related to movements in unfunded ERDCs will only be changed at a subsequent price control, except* *where through structural changes it can be clearly demonstrated that they have been fully funded.*

11. *Subject to any applicable incentive mechanism, increases in pension costs against allowances will therefore in general be recoverable from (or decreases recaptured for) consumers on an NPV-neutral basis.*

Unexpected lump sum deficit payments

1.25. *These tend to occur in instances in change of corporate control, or through corporate activity within the NWO's wider group. Whilst one can understand the trustees taking the opportunity to repair the deficit faster, it is not clear why consumers should pay an accelerated profile.*

1.26. *We will review the payment of the lump sum compared to what the position would have been if the deficit had been spread over a number of years. This is to ensure that consumers have either positively benefited from, or have not been disadvantaged by the accelerated funding. Where a company cannot satisfy us that the accelerated payment has been in the interests of customers (as opposed to shareholders or scheme members), we will treat the payment as having been made over the period according to the original deficit recovery plan.*

Principle 6 - Severance - Early Retirement Deficiency Contributions

Companies will also be expected to absorb any increase (and may retain the benefit of any decrease) in the cost of providing enhanced pension benefits granted under severance arrangements which have not been fully matched by increased contributions

1.27. **Since** 31 March 2004, **Early Retirement Deficiency Contributions** (ERDCs) whether fully funded, partially funded or totally unfunded, have been a matter solely for shareholders.

1.28. The principle requires an adjustment to be made to the allowances for future price controls to exclude the impact of ERDCs resulting from redundancy and re-organisation, which have been offset by use of surpluses, rather than being funded by increased contributions.

1.29. This provides for consistent treatment with other restructuring and rationalisation costs. For this purpose, it will be necessary to roll forward the amounts of unfunded ERDCs arising in each year of a previous price control period using the *following methodology:*

- *At each control, companies will have supplied details of amounts relating to ERDCs. An adjustment is made to the Regulatory Fraction to reduce deficit funding (meaning the shareholders would in effect need to make good the shortfall).*

- *These unfunded ERDCs theoretically still exist at the next control in most cases. We accept that, where schemes have subsequently been taken over and scheme deficits paid off at that time this will also include the ERDCs.*

- *To derive the movements and obtain an updated position at the next control:*
    - *We take the position at the last control, rebased using RPI to real prices.*
    - *An adjustment is then made for companies where the scheme deficit has been cleared, by for example a take-over and subsequent funding in total of the deficit.*
    - *This revised sum is then rolled forward each year to create a closing forecast position at the end of the last price control by:*
        - *adding expected returns (using the cost of capital for that control).*
        - *deducting the proportion of the deficit payments that were disallowed in that control. The expected return is used (rather than actual returns) since this is the figure on which the original valuation was based.*
        - *The resulting forecast values of ERDCs at the end of the control period are compared to the deficits that are being forecast at the end of the control and a percentage is calculated. This is then used to reduce the regulatory fraction.*

Example:

ERDC reduction calculation					
	2005/06	2006/07	2007/08	2008/09	2009/10
B fwd	25.0	23.4	22.0	20.4	18.6
Return at cost of capital	1.4	1.3	1.2	1.1	1.0
Deficit Payments (ERDC fraction)	(3.0)	(2.7)	(2.9)	(2.9)	(2.9)
C fwd	23.4	22.0	20.4	18.6	16.8
Deficit Payments (distribution element)	(20.0)	(18.0)	(19.0)	(19.0)	(19.0)
% of deficit reduced for ERDCs in DPCR4	15%				

- *To the extent that actual contributions in any period fall short of or exceeds the assumed contribution, the amount of the shortfall or excess needs to be rolled forward to the date of the actuarial valuation on which the future price control allowance is based, and*

- *In setting a future price control, the allowance for pension costs would be set to reflect the position that would have arisen had contributions in the preceding period equalled the level assumed in setting the price control for that period. This would require addition of the rolled forward amount of any excess contributions and deduction of the amount of any shortfall to/from the value of the scheme assets assumed by the actuarial valuation, and re-projecting future costs accordingly taking account of investment returns. This will have the result of logging up or down variances resulting from changes in contribution rates occurring between price control reviews. To avoid double counting, this amendment will need to be carried through to subsequent reviews.*

Defined Contribution Pension Schemes

1.30. The principles are particularly relevant to DB scheme costs. We typically benchmark costs including DC schemes, which approach effectively covers the application of the first principle. As we do not assess DC scheme costs by reference to the scheme itself, in practice we do not have to consider principle 2 (i.e. such non-regulated business costs are automatically excluded by the way we assess costs generally). Since DC contribution rates are not directly driven by actuarial assumptions or investment performance, principles 3 and 4 are not applicable. Since deficits do not arise on DC schemes, nor do contribution rates have to rise as a result of actuarial assumptions, we do not have to consider under/over recovery.

Appendix 4 - DPCR5 methodologies

1.1. We set out the methodologies we have applied at DPCR5 for Initial Proposals, as subsequently updated by the 5 October 2009 update letter on DPCR5[19]:

- Calculating the regulatory fraction
- Early Retirement Deficit Contributions – ERDCs
- Normal ongoing service pension contributions
- Pensions true up

Regulatory Fraction

1.2. The Regulatory Fraction represents the element of the scheme's pension deficits which relates to activity of the distribution business (i.e. the licensed business) and which ultimately, under the pension principles, is funded by customers.

1. In principle, we have retained the DPCR4 position of the 80/20 split as a starting point and will not re-open that settlement, except for EDFE EPN and CE YEDL, which at DPCR4 were at 100 per cent.
2. Adjustments are then made to take account of scheme restructuring (mergers, bulk transfers in and out) to arrive at a new fraction.
3. This new fraction (or appropriate rate for each year of DPCR4) will apply subject to the DPCR4 true up. Where schemes have totally restructured and now are limited to distribution employees, the allowed proportion will be revised to 100 per cent, subject to a case-by-case review.
4. For schemes which had no allowed proportion in DPCR4, the appropriate fraction has been determined from data provided by the DNO. There has been correspondence with individual licensees regarding their own fractions.
5. Where during DPCR4 schemes have merged or otherwise restructured and in DPCR5, the regulatory fraction will be shown as a percentage of the scheme total. This will mean that it is not possible to compare directly the DPCR4 percentage with that for DPCR5.
6. This new percentage will be subject to a deduction in respect of our view of the movements in the unfunded ERDCs from pre 1 April 2004 (see below).
7. For the indicative calculations of deficit funding described above we have wherever possible used the new regulatory fraction as determined in the preceding methodology. In some instances, however, this was understating the

[19] Electricity Distribution Price Control Review - October update covering letter http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=323&refer=Networks/ElecDist/PriceCntrls/DPCR5

required funding (for example where companies had already deducted the regulatory fraction from their forecasts) and in these cases we have used either 80 per cent or 100 per cent, as appropriate, less any ERDC adjustment.

Early Retirement Deficit Contributions

1.3. In DPCR4, most companies supplied details of amounts relating to employees who had been allowed to retire early but where the company had not paid into the scheme to cover the future cost of these pensions. An adjustment was made to the Regulatory Fraction to reduce deficit funding (meaning the shareholders would in effect need to make good the shortfall).

1.4. These unfunded ERDCs theoretically still exist for DPCR5 in most cases. We accept that, where schemes have subsequently been taken over and scheme deficits paid off at that time this will also include the ERDCs.

1.5. To arrive at the revised numbers we have:

1. Taken the DPCR4 position and rebased using RPI to 2007/08 prices.
2. An adjustment has then been made for companies where the scheme deficit has been cleared, by for example a take-over and subsequent funding in total of the deficit.
3. This revised sum is then rolled forward each year to create a forecast 2010 position by:
a. adding expected returns (using the cost of capital for DPCR4).
b. deducting the proportion of the deficit payments that were disallowed in DPCR4. The expected return is used (rather than actual returns) since this is the figure on which the original valuation was based.
4. The resulting values of ERDCs at 2010 are compared to the deficits that are being forecast for 2010 and a percentage is calculated. This is then used to reduce the regulatory fraction.

Table A4.1 ERDC movements calculation

ERDC reduction calculation					
	2005/06	2006/07	2007/08	2008/09	2009/10
B fwd	25.0	23.4	22.0	20.4	18.6
Return at cost of capital	1.4	1.3	1.2	1.1	1.0
Deficit Payments (ERDC fraction)	(3.0)	(2.7)	(2.9)	(2.9)	(2.9)
C fwd	23.4	22.0	20.4	18.6	16.8
Deficit Payments (distribution element)	(20.0)	(18.0)	(19.0)	(19.0)	(19.0)
% of deficit reduced for ERDCs in DPCR4	15%				

Normal ongoing service pension contributions

1.6. These are calculated from the FBPQ submissions, from which unfunded items are excluded and to which a scaling factor has been applied:

1. The pension element of business support costs is deducted from the total pension costs and computed separately.
2. The pension costs identified as atypical, non-distribution business (including de minimis costs), relevant and non-relevant excluded services and sole use connections are all excluded from the level of future funding.
3. An adjustment is made for reconciling items where the company have not been able to explain satisfactorily why the pensions table should show greater costs than those identified in the main FBPQ tables.
4. Some companies have included RPE factors as uplift to their pension costs. These are allowed pro rata to the value allowed into totex (i.e. the element that applies to non-allowed items is disallowed) and this value forms part of the adjustment shown in (3) above.
5. The resultant total of normal pension costs is then scaled in line with companies' cost reductions (using the latest data but equivalent to table 7.4 of the Initial Proposals - document 94/09). The scaling factor reflects the overall reduction in costs that has been made to companies' FBPQ submissions (excluding the IQI additional income, which is a reward to companies and not a cost).
6. The PPF levy and administration costs are allowed subject to a cap on the fixed rate charge of £0.1m and for the risk based charge £0.4m per DNO. We have reviewed the actual cash costs of the PPF levy and administration costs in DPCR4 and the projections and compared them across all companies. In general, it is difficult to forecast the likely movements in the Levy and therefore use a reasonable estimate across DNOs. We have also considered whether DNOs D&B Failure Scores are low, indicating perhaps that a company has not done all it could to mitigate the levy and have capped its forecast. The true up mechanism at the next review will address the position if this assumption proves incorrect.
7. After applying a scaling factor to total PPF and administration fee costs the total is allowed pro rata to the ratio of normal allowed pension costs for the distribution business. Part of these costs are assumed to relate to Business Support costs and are therefore deducted from normal pension costs in the proportion of Business Support costs to normal allowed pension costs.
8. Business support costs are allowed less the scaling factor but adding back the Business Support element of the PPF levy (calculated in (7) above).

Table A4.2: Example of normal pension contributions adjustments:

	2010-11	2011-12	2012-13	2013-14	2014-15	Total
	£m	£m	£m	£m	£m	£m
Total from F7 reconciliation in June FBPQ	9.1	9.6	9.7	10.0	10.0	48.2
Less:						
Business support	(0.6)	(0.6)	(0.6)	(0.6)	(0.6)	(3.0)
Relevant excluded services	0.0	0.0	0.0	0.0	0.0	0.0
Non-relevant excluded services	(0.4)	(0.4)	(0.4)	(0.4)	(0.4)	(2.0)
Non-distribution (inc de minimis)	(0.2)	(0.2)	(0.2)	(0.2)	(0.2)	(1.1)
Sole use connections	(0.4)	(0.4)	(0.4)	(0.4)	(0.4)	(2.1)
Atypical	0.0	0.0	0.0	0.0	0.0	0.0
Less PPF and admin costs adjustment	(0.7)	(0.6)	(0.6)	(0.7)	(0.6)	(3.0)
Less adjustment for reconciling items	(0.4)	(0.3)	(0.3)	(0.4)	(0.3)	(1.7)
Totex	6.4	7.0	7.1	7.2	7.4	35.2
Less scaling factor 96.4%	(0.2)	(0.3)	(0.3)	(0.3)	(0.3)	(1.3)
PPF & Admin costs allowed	0.3	0.3	0.3	0.4	0.3	1.6
Total totex to be funded	6.5	7.1	7.2	7.3	7.5	35.6
Business Support	0.6	0.6	0.6	0.6	0.6	3.0

Pensions true up

1.7. A calculation has been made to restore companies to the position they would have achieved if their actual pension payments had been forecast perfectly in the last price review. The calculation is made on the basic building blocks used with the approach being simplified as far as possible, as follows:

1. The calculation takes the actual (including forecast) numbers for DPCR4 and compares them to the allowed funding (all in constant prices). The actual numbers include payments relating to the PPF levy (fixed and risk based) and are those used to populate the RAV additions table. Note: If collected through an addition to the normal pension costs these are already within the actual cash payments; and if the PPF levy has been paid directly by the DNO (and reported in the HR & Non-op training activity) these have added to actual pension costs.

2. The difference is then treated as it would have been for DPCR4 funding i.e. 57.7 per cent is treated as an addition to RAV and the remainder as opex.

3. The RAV element is then used to calculate the missing return on RAV and depreciation.

4. The missing RAV return and depreciation are then used together with the opex element, with an offset for changed tax allowances (at 30 per cent as modelled) that would have been gained to show the 'cash' position that would have occurred.

5. A return (at the DPCR4 WACC) is then allowed each year on the value of the 'cash' to bring the total to the 31 March 2010 position. This is then added into the financial model to give additional revenue in DPCR5.

6. The remaining RAV will be funded through the rolled forward RAV in the normal way.

See example below:

Table A4.3: Example of pension true up calculation

£m 2002/03 prices							Notes
DPCR4 allowance	**2006**	**2007**	**2008**	**2009**	**2010**	**Total**	
Capex	28.9	24.2	25.4	26.0	27.7	132.1	
Opex	21.2	17.8	18.6	19.0	20.3	96.9	
	50.0	42.0	44.0	45.0	48.0	229.0	Allowance per FP
Actual pension spend	Nominal prices			£m 2007/08 prices			
Normal	17.0	17.0	17.5	18.0	19.0	88.5	
PPF Levy	0.0	0.0	0.1	0.2	0.2	0.5	
Deficit	40.0	37.0	35.0	36.0	36.0	184.0	
	57.0	54.0	52.6	54.2	55.2	273.0	Total spend
£m 2002/03 prices							
Actual pension spend							
Normal	15.6	15.1	15.0	15.5	16.3	77.5	Deflate to 2002/03
Deficit	36.8	32.8	29.9	30.8	30.8	161.0	
	52.4	47.9	44.8	46.3	47.1	238.5	
Capex /opex split DPCR4 basis							
Capex	30.2	27.6	25.9	26.7	27.2	137.6	Split per DPCR4 assumption
Opex	22.2	20.2	19.0	19.6	19.9	100.9	
	52.4	47.9	44.8	46.3	47.1	238.5	
£m 2002/03 prices							
Difference							
Capex	1.4	3.4	0.5	0.7	(0.5)	5.5	Difference to be addressed
Opex	1.0	2.5	0.4	0.5	(0.4)	4.0	
	2.4	5.9	0.8	1.3	(0.9)	9.5	
RAV impact							
Opening	0.0	1.4	4.7	4.9	5.4		
Additions	1.4	3.4	0.5	0.7	(0.5)		Capex from above
Depreciation	0.0	(0.1)	(0.2)	(0.3)	(0.3)		Over 20 years
Closing	1.4	4.7	4.9	5.4	4.6		
Depreciation period 20							
Additional tax saving	0.7	1.8	0.3	0.4	(0.3)		100% allowances
Tax rate	30%	30%	30%	30%	30%		As modelled
£m 2002/03 prices							
Amounts to be adjusted						Total	
RAV return 5.545%	0.0	0.2	0.3	0.3	0.3	1.0	Return on RAV not funded
Opex	1.0	2.5	0.4	0.5	(0.4)	4.0	Opex not funded
Depreciation	0.0	0.1	0.2	0.3	0.3	0.9	
Tax benefit	(0.7)	(1.8)	(0.3)	(0.4)	0.3	(2.9)	
						3.1	
Remaining RAV					4.6	4.6	
£m 2007/08 prices						Total	
RAV return	0.0	0.2	0.3	0.3	0.3	1.2	
Opex	1.2	2.9	0.4	0.6	(0.4)	4.7	
Depreciation	0.0	0.1	0.3	0.3	0.4	1.0	
Tax benefit	(0.8)	(2.1)	(0.3)	(0.5)	0.3	(3.4)	
Cash funding	0.4	1.1	0.7	0.8	0.6	3.6	
Time value of cash	0.4	1.1	0.7	0.8	0.6	**3.6**	
Years remaining	4.5	3.5	2.5	1.5	0.5		Years to 2010
Remaining in RAV					5.4	**5.4**	Already added to RAV

Appendix 5 – The Authority’s Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority (“the Authority”), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.[20]

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly[21].

1.4. The Authority’s principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of existing and future consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- the need to secure that all reasonable demands for electricity are met;
- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them[22];
- the need to contribute to the achievement of sustainable development; and
- the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.[23]

[20] entitled “Gas Supply” and “Electricity Supply” respectively.
[21] However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.
[22] under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.
[23] The Authority may have regard to other descriptions of consumers.

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- promote efficiency and economy on the part of those licensed[24] under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and
- secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

- the effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation[25] and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

[24] or persons authorised by exemptions to carry on any activity.
[25] Council Regulation (EC) 1/2003

Appendix 6 - Glossary

C

Capital Expenditure (Capex)

Expenditure on investment in long-lived distribution assets, such as underground cables, overhead electricity lines and substations.

D

Defined benefit (DB) pension scheme

Pension scheme in which an employee's pension is based on number of years of service and final salary (or in newer schemes average salaries over the employment period) with sponsoring employer(s).

Defined contribution (DC) pension scheme

Pension scheme in which the benefits will be dependent on contributions to, and growth of, the fund and the fund manager's, investment and other attributable costs.

Distribution Network Operators (DNOs)

A DNO is a company which operates the electricity distribution network which includes all parts of the network from 132kV down to 230V in England and Wales. In Scotland, 132kV is considered to be a part of transmission rather than distribution so their operation is not included in the DNOs' activities.

There are 14 DNOs in the UK which are owned by seven different groups:

CN West	Central Networks West plc licence holder for West Midlands
CN East	Central Networks East plc licence holder for East Midlands
ENW	Electricity North West Limited licence holder for North West England
CE NEDL	Northern Electric Distribution Limited licence holder for North East England
CE YEDL	Yorkshire Electric Distribution Limited licence holder for Yorkshire
WPD S Wales	Western Power Distribution (South Wales) plc, licence holder for South Wales
WPD S West	Western Power Distribution (South West) plc, licence holder for South West England
EDFE LPN	EDF Energy Networks (LPN) plc, licence holder for south east England
EDFE SPN	EDF Energy Networks (SPN) plc, licence holder for London
EDFE EPN	EDF Energy Networks (EPN) plc, licence holder for eastern England
SP Dist	SP Distribution Limited, licence holder for central and southern Scotland
SP Manweb	SP Manweb plc, licence holder for Merseyside and North Wales
SSE Hydro	Scottish Hydro Electric Power Distribution Limited, licence holder for northern Scotland
SSE Southern	Southern Electric Power Distribution plc, licence holder for southern England

Distribution Price Control Review 4 (DPCR4)

Distribution price control review 4. This price control runs from 1 April 2005 until 31 March 2010.

Distribution Price Control Review 5 (DPCR5)

Distribution price control review 5. This price control is expected to run from 1 April 2010 until 31 March 2015.

E

Early Retirement Deficiency Contributions (ERDCs)

Cost of providing enhanced pension benefits granted under severance arrangements which have not been fully matched by increased contributions.

ESPS

Electricity Supply Pension Scheme.

Ex ante

Refers to a value or parameter set down before the commencement of the price control period

Ex post

Refers to a value or parameter ascertained after the commencement of the price control period

F

Fast money

The portion of allowed expenditure for a network licensee which does not pass into RAV

G

Gas distribution networks (GDNs)

GDNs transport gas from the National Transmission System to final consumers and to connected system exit points. There are currently eight GDNs in Great Britain which comprise twelve local distribution zones, owned by four groups:

NGG, the GT licence holder for the North West, West Midlands, East England and London GDNs
Northern Gas Networks (NGN), the GT licence holder for Northern GDN
Scotia Gas Networks (SGN), the GT licence holder for Southern GDN & Scotland GDN

Wales & West Utilities (WWU), the GT licence holder for Wales & West GDN.

Gas Distribution Price Control Review (GDPCR)

The review of the price control applying to gas distribution networks. The review extended the existing price control for the year 2007-08 and reset the control for the period commencing 1 April 2008.

Gas Transporter (GT)

The holder of a Gas Transporter's licence in accordance with the provisions of the Gas Act 1986.

I

Information Quality Incentive (IQI)

The IQI is a mechanism for setting price control allowances that provides ex ante incentives for DNOs to submit accurate forecasts of their expected expenditure and provides incentives for efficiency improvements once the price control has been set.

N

NWO(s)

Collectively the electricity and gas distribution and transmission network operators (DNOs, TOs, and GDNs).

National Grid Gas (NGG)

The gas transporter (GT) licence holder for the North West, West Midlands, East England and London GDNs. NGG also hold the GT licence for the gas transmission system (NGGT).

National Grid Electricity Transmission (NGET)

NGET owns and maintains the high-voltage electricity transmission system in England and Wales and operates the system across Great Britain.

Net present value (NPV) neutral

Alternative revenue profiles are net present value neutral if they have the same NPV. We usually use this term in the context of spreading revenues over time (i.e. a price control period) where the costs that they represent have already been incurred, or in comparing different profiles of allowed revenue.

O

Operating expenditure (opex)

Expenditure on operating and maintaining the network, e.g. fault repair, tree cutting, inspection and maintenance, engineering and business support costs.

P

Pass through (of costs)

Costs for which companies can vary their annual revenue in line with the actual cost, either because they are outside the NWO's control or because they have been subject to separate price control measures

Pension Protection Fund (PPF)

The Pension Protection Fund established to pay compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation.

PPF Levy

The PPF is financed by a levy on schemes, this levy consists of a fixed element (based on scheme liabilities), and a risk based element (based on the perceived insolvency risk of each scheme). Additionally there is an administration levy charged to cover the PPF running costs.

R

Regulatory asset value (RAV)

The value ascribed by Ofgem to the capital employed in the licensee's regulated distribution or (as the case may be) transmission business (the 'regulated asset base'). The RAV is calculated by summing an estimate of the initial market value of each licensee's regulated asset base at privatisation and all subsequent allowed additions to it at historical cost, and deducting annual depreciation amounts calculated in accordance with established regulatory methods. These vary between classes of licensee. A deduction is also made in certain cases to reflect the value realised from the disposal of assets comprised in the regulatory asset base. The RAV is indexed to RPI in order to allow for the effects of inflation on the licensee's capital stock. The revenues licensees are allowed to earn under their price controls include allowances for the regulatory depreciation and for the return investors are estimated to require for providing the capital.

Regulatory Fraction

The proportion of a company's pension scheme that relates to the licensed activity, and which is funded through price controlled charges.

RPI-X@20

Ofgem has set out its intention to review the regulatory regime for energy networks. The two-year review will examine whether the current approach will continue to deliver customers reliable, well-run networks with good service at reasonable prices amid growing investment challenges faced by the energy networks in the future.

RPE - Relative Price Effect

The real movement in costs of a licensee after normal price inflation (or deflation) as measured by RPI is excluded.

S

Salary Sacrifice

A salary sacrifice arrangement in respect of pension scheme benefits is where the member's salary is reduced by the amount of the member pension contributions that the member would normally pay, and instead the employer meets the cost of the member pension contributions.

Scheme sponsor(s)

A licensee or affiliate of the licensee, as employers, who individually or collectively sponsor a company or group occupational pension scheme, one of whom will be the principle employer. The employer(s) plays a vital role as the scheme sponsor. It effectively underwrites the risks that the scheme is exposed to, including existing underfunding, longevity, investment and inflation.

T

Totex

Total expenditure, i.e. capex plus opex but excluding pension deficit repair costs.

TPR

The Pensions Regulator, established under the Pensions Act 2004.

Transmission Price Control Review (TPCR4)

The TPCR established the price controls for the transmission licensees which took effect in April 2007 for a 5-year period. The review applies to the three electricity transmission licensees, National Grid Electricity Transmission, Scottish Power Transmission Limited, Scottish Hydro-Electric Transmission Limited and to the licensed gas transporter responsible for the gas transmission system, NGG.

Transmission Owners

Own the high-voltage electricity transmission system in Great Britain:
NGET owns and maintains the high-voltage electricity transmission system in England and Wales. Also the system operator for Great Britain.
SHETL Scottish Hydro-Electric Transmission Limited, the electricity transmission licensee in northern Scotland.

SPT Scottish Power Transmission Limited, the electricity transmission licensee in southern Scotland.

Triennial valuation

A detailed actuarial review of a pension scheme's assets in comparison to its liabilities in present value terms. It is used to determine ongoing contributions and any deficit recovery plan.

Weighted Average Cost of Capital (WACC)

This is the weighted average of the expected cost of equity and the expected cost of debt.

Appendix 7 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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