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Price Control Treatment of Network Operator Pension Costs Under Regulatory Principles

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Target audience: Network companies, pension scheme trustees, consumers and their representatives, trade unions and other employee representatives, other interested stakeholders.

Overview:

Ofgem regulates the electricity and gas network monopolies to protect the interests of present and future consumers. We set a price control, currently, every five years for each group of network operators (NWOs). The price control sets the total revenue allowances that each NWO can collect from business and domestic 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.

During 2008 and 2009, we carried out a series of consultations reviewing the practical application of our existing pension principles and concluded the review by refining the way we would apply them to network operator price controls going forward. We used the results of this consultation in setting pension cost allowances for electricity distributors for the current price control period (DPCR5) which runs until March 2015. We stated that the results would apply to all network operators going forward and that we would clarify the position for transmission and gas distribution in a document during 2010.

This document meets that commitment, confirming the DPCR5 approach and clarifying how we will apply it to the gas distribution and gas and electricity transmission network operators.

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Context

Ofgem's principal objective is to protect the interests of existing and future consumers. We regulate the network operators by setting a price control every five years. We also regulate the structure of their network charges 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 applied these through three successive price control reviews – covering 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 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 throughout 2008 and 2009. 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 three stakeholder workshops.

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 and organisations over time.

This review covered all the price controlled energy networks. We published our conclusions in DPCR5 Final Proposals applying solely to electricity distribution companies as we concluded that price control review at the same time. In DPCR5 we made it clear that the conclusions of the pensions review would apply to all network operators going forward and that we would publish a short document, during 2010, setting out how we will apply the principles at future price controls.

In this paper we restate these decisions and set out the way we expect them to be applied in the future in particular for the next price control period for gas distribution companies (GDPCR2) and for electricity and gas transmission companies (TPCR5), both of which commence in April 2013. The particular treatment for the one year price control which will apply for Transmission from April 2012 to March 2013 (the rollover) is not covered in this document although our approach will be based on applying as much of the DPCR5 approach as is practicable. The treatment of pension costs for the rollover will be covered in the rollover scope decision document which we expect to publish in July 2010.

We also refer to the specific issues relevant to forthcoming price controls and explore the effects that our RPI-X@20 review of the regulation of networks might have on aspects of implementation (although the review is not addressing pension funding directly).

This document is not intended to break any new ground with regard to the price control treatment of pension costs for network operators but simply to provide greater detail about the application of our decisions at future price control reviews.

Associated documents

- Price Control Pension Principles – Ofgem Consultation Document 120/08 – 7 August 2008

  http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=98&refer=Networks/ElecDist/PriceCntrls/DPCR5

- Open letter to network operators 17 December 2008 – Price Control Principles Questionnaire

  http://www.ofgem.gov.uk/Networks/Documents1/Pensionper cent20questionnaireper cent20coveringper cent20letter.pdf

- Price Control Pension Principles – Second Consultation Document 96/09 – 31 July 2009

  http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=Priceper cent20controlper cent20pensionper cent20Principlesper cent20secondper cent20FINAL.pdf&refer=Networks

- Price Control Pension Principles – Third Consultation Document 125/09 – 16 October 2009

  http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=Priceper cent20Controlper cent20Pensionper cent20Principlesper cent20thirdper cent20consultationper cent20Final.pdf&refer=Networks

- Electricity Distribution Final Proposals 144/09 - 7 December 2009

  http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR5/Documents1/FP_1_Core%20document%20SS%20FINAL.pdf

- Electricity Distribution Price Control Review Final Proposals - Allowed revenue financial issues 147/09 – 7 December 2009

  http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=371&refer=Networks/ElecDist/PriceCntrls/DPCR5

- Electricity Distribution Price Control Review Final Proposals - Financial Methodologies 148/09 – 7 December 2009

  http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=372&refer=Networks/ElecDist/PriceCntrls/DPCR5

- Gas Distribution Price Control Review Final Proposals 2007-13

  http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=504&refer=Networks/GasDistr/GDPCR7-13

- TPCR4 Final Proposals 2007-13

  http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4/ConsultationDecisionsResponses/Documents1/16342-20061201_TPCRper cent20Finalper cent20Proposals_in_v71per cent206per cent20Final.pdf

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Summary

This document is intended to draw together and clarify the conclusions of the pensions review and Ofgem's position on the funding of pension costs for the main energy network operators in Great Britain. This follows the extensive review and consultation we carried out in 2008 and 2009. As we concluded the pensions review at the same time as DPCR5, we set out our conclusions in DPCR5 Final Proposals with particular reference to the electricity distribution network operators (DNOs). These proposals were all accepted by the DNOs. Although we made it clear that the conclusions would apply to all network operators we also undertook to publish a specific pensions' decision document during 2010 to provide further clarity, particularly for transmission and gas distribution operators as some of the DPCR5 proposals are specific to electricity distribution companies.

We recognise that the treatment of pension costs is an important area that has implications for energy consumers and a number of stakeholder groups. Pension costs and their treatment in price controls are also strongly influenced by protections to pension arrangements put in place at privatisation and great uncertainty about the current (and future) levels of liabilities.

In the chapters below we restate and clarify the approach to the funding of pensions outlined in the DPCR5 Final Proposals documents and outline how this translates to the upcoming Gas Distribution and Transmission price controls (GDPCR2 and TPCR5 respectively).

In particular, we provide further information on our approach to ongoing and deficit repair costs, including the scope of the regulatory funding commitment to existing deficits associated with accrued pension rights. We also address supplementary issues including scheme surpluses, buy-in/buy-out transactions and exceptional events such as business sales or mergers.

It is important to note that the specific pension cost proposals for future price control settlements will be included in the consultation and decision process for the particular price control concerned. However, we will handle the issues arising in accordance with the principles in this paper.

This document provides:

- The relevant background and objectives,
- A summary of our pension principles,
- A section which deals with the application of our decisions on ongoing pension scheme and deficit repair costs primarily for defined benefit schemes, and
- Our approach to exceptional events such as corporate transactions.

The appendices provide the full text of our pension principles.

1. Introduction and objectives

Introduction

1.1. Ofgem's principal objective is to protect the interests of existing and future consumers. The interests of such consumers are their interests taken as a whole, including their interests in the reduction of greenhouse gases and in the security of the supply of gas and electricity to them. We do this by promoting effective competition wherever appropriate and through regulation where necessary. In carrying out its duties Ofgem is required to have regard to a number of factors including the need to secure that licence holders are able to finance the activities which are the subject of obligations on them.

1.2. This document sets out the way we expect to apply decisions we have reached on the price control treatment of network operators' pension costs (see chapter three). The associated documents give the background to these decisions and the Pension Principles which have informed them.

Energy network operators

1.3. Ofgem regulates 22 companies, which are licensed to transmit or distribute gas or electricity in specified geographical areas in Great Britain[1]. The licensed companies are generally part of larger corporate groups and, in many cases, affiliated companies are bound into the 'network business' under contractual relationships. In a similar vein, the pension schemes to which this document refers are often managed at corporate group level and may cover more than one network operator. Network business staff are often employees of a company other than the licensed entity.

1.4. For the purposes of addressing pension costs and allowances, it is each substantive network business that we consider and this is also relevant in ascertaining the attributable regulatory fraction of scheme deficits under our Pension Principle 2. This is because the network business comprises the resources, including the people, which the licensee needs to carry out its activities and comply with its licence obligations. This is consistent with the consideration of other costs in price control reviews in treating the network business as if all the costs are incurred in the licensed entity. This is particularly relevant to pension costs and their tax treatment

[1] National Grid Gas plc holds two gas transporter licences - one refers to its role as owner and operator of the GB gas transmission network and the other refers to its operation of four gas distribution network areas. There are also a number of independent network operators, but they are not directly covered by the main price control settlements and so are not referred to here.

in setting price control allowances. Conversely, requirements imposed on 'the employer' by legislation or scheme rules will usually be obligations on the licensed company which owns the network system assets and derives the revenues from their operation. In the remainder of this document we use the term Network Operator (NWO) to refer to either or both of the licensee and the substantive network business as appropriate to the context.

Background to the issues affecting pension costs

1.5. The defined benefit (DB) pension schemes sponsored by most NWOs have their roots in employee remuneration packages which existed before privatisation of the publicly owned energy infrastructure. The present position reflects that legacy together with the relevant legislation and scheme rules in place at the time of privatisation or, for gas transporters subsequent to their sale by National Grid Gas (NGG). However, it also reflects subsequent changes to industry structures and the ongoing need for NWOs to attract and retain sufficient numbers of skilled and experienced staff. In making our decisions on the treatment of pension costs we have taken account of relevant differences between industry sectors.

1.6. In common with companies in other commercial sectors, NWOs have faced increasing costs to meet pension commitments, particularly those relating to defined benefit schemes. For these schemes in particular, future funding requirements are highly uncertain because factors such as fund investment returns and longevity assumptions can vary considerably. Some of these factors, such as longevity, are linear in nature whereas others are more cyclical (investment returns). Recent changes to requirements in financial reporting standards have also tended to bring levels of pension liabilities into sharp relief.

1.7. NWOs, as employers, have firm obligations to the pension schemes they sponsor, although nearly all of their defined benefit schemes have been closed to new members. A review[2] of scheme investment profiles carried out for us by the Government Actuary's Department (GAD) found them generally to be in line with schemes in other, broadly comparable companies. Most NWOs now offer defined contribution (DC) schemes to new employees that eliminate the funding level risk for the employer albeit by largely transferring this risk to the employee.

Interested stakeholders

1.8. We sought the views of a number of key stakeholders during the 2008-09 consultation process on NWO pension arrangements and these have been reflected where possible in our decisions on pension costs. The key stakeholders are:

[2] http://www.ofgem.gov.uk/Networks/Documents1/Ofgem%20Report-finalsigned.pdf

- The network operators, their corporate groups and shareholders,
- Network users, energy consumers and their representatives,
- NWO employees, trade unions and pension trustees,
- The Pensions Regulator (TPR),
- The Pension Protection Fund (PPF), and
- Debt and equity finance providers.

Constraints imposed by legislation and scheme rules

1.9. At the time of privatisation of the electricity industry in 1990, the government made regulations[3] protecting the existing and future pension rights of employees in the Electricity Supply Pension Scheme. The regulations effectively prevent any curtailment of pension rights for those employees who are referred to as 'protected persons'. Although there are no equivalent regulations covering the gas sector, scheme rules nonetheless restrict to some extent the ability of employers to vary benefit levels or contribution levels.

Decisions made in DPCR5 Final Proposals

1.10. The decisions made and outlined in the DPCR5 Final Proposals document 147/09 are summarised below. These primarily related to the DNOs that were subject to that price control review.

Deficit funding

- To allow the DNOs to recover over time from customers all pension deficits (related to the distribution business and subject to our economic and efficient test) as accrued immediately prior to the next price control period (1 April 2010 in the case of DNOs),
- to apply a 15 year notional deficit funding period across all companies,
- to undertake a full efficiency review of any specific DNO pension schemes where an assessment made by GAD at the end of the regulatory period suggests this is required, and

[3] The Electricity (Protected Persons) (England and Wales) Pension Regulations 1990 and The Electricity (Protected Persons) (Scotland) Pension Regulations 1990 and The Electricity Supply Pension Scheme (Transfer Date Amendments) Regulations 1990

- for DPCR5, to set allowed revenues based on valuations as of 30 September 2009 using values provided by the DNOs supported by actuarial reports with an adjustment for the actual March 2010 values in DPCR6.

Ongoing pension costs

- To use benchmarking to set ex ante allowances for future reviews, but not in DPCR5,

- for DPCR5, to provide the DNOs revenue allowances to recover the full value of their ongoing pension cost projections. In recognition of the limited control under relevant legislation that DNOs have over their staff who are protected persons[4] (just less than 50 per cent of the workforce), the DNOs will carry only 20 per cent of any extra costs they incur above the upfront allowance, and

- to provide an incentive for DNOs to control their ongoing costs, the DNOs will be allowed to keep 50 per cent of any under-spend in the DPCR5 period.

Application issues

- To adopt all of the application principles as set out in the third pension consultation with further clarification on the treatment of bulk transfers and on assessing the regulatory fraction for pipes or wires only businesses.

1.11. We made clear in our DPCR5 Final Proposals documents that our decisions would apply to all NWOs and set out our position on the different cost areas relating to pension provision. In the following chapters we set out how we will apply our approach to pensions to all NWOs and in particular for electricity and gas transmission and gas distribution companies at both TPCR5 and GDPCR2.

[4] As defined in the Electricity (Protected Persons) (England and Wales) Pension Regulations 1990 in relation to the Electricity Supply Pension Scheme and in the Electricity (Amendment of Scottish Pension Schemes) Regulations 1990.

2. Ofgem's Pension Principles

Ofgem's Pension Principles

2.1. We first set out a set of Pension Principles in 2003[5], with the intention of improving regulatory certainty in this area and promoting equitable treatment for the different stakeholder groups. During 2008 and 2009 we conducted a series of consultations to inform a review of the Pension Principles and their implementation in price controls. The review was initially prompted by concerns about the possibility of stranded surpluses arising in the Gas Distribution Networks (GDNs) and sought to affirm that the Pension Principles were working. It was extended to consider the affordability of funding for NWO pension provision against the backdrop of defined benefit scheme closures across the economy. It was also our intention to improve transparency on the regulatory position for this issue, and particularly how we would go about deciding on what pension costs were economic and efficient and should be funded by customers through the price control settlement.

2.2. This work has enabled us to reaffirm our Pension Principles, provide clarity on their operation and confirm the way we will approach the different categories of pension costs in future price control reviews for network operators. The Pension Principles are listed below and are reproduced in full at Appendix 1 to this document.

2.3. The Pension Principles are:

- 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.

- 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.

- Principle 3 – Stewardship considerations in setting allowances and making ex-post adjustments

  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.

[5] Developing Network Monopoly Price Controls 2003

- Principle 4 – Use of actuarial valuations and scheme-specific funding requirements

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

- 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.

- Principle 6 – Early retirement deficiency contributions (ERDC)

  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.

3. Application of our decisions on the price control treatment of NWOs' pension costs

3.1. Our DPCR5 Final Proposals made clear that our decisions would apply to all NWOs and explained our position on the different cost areas relating to pension provision. These decisions are set out in the following sections. Where there were specific departures in DPCR5 from the longer term treatment we expect to apply going forward we have made this clear below.

3.2. It should also be borne in mind that our RPI-X@20 review of the regulation of networks is considering possible alternatives to the existing five-year price control format. RPI-X@20 is not reviewing pension funding and the treatment determined at DPCR5, as clarified here, will apply. If the outcome of the RPI-X @20 review is an increase in the length of price control periods we will provide clarity regarding the impact on pension cost allowances in the relevant price control.

3.3. Ofgem's role is to set appropriate price control allowances for NWOs, consistent with our principal objective to protect the interests of existing and future consumers, having regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations on them. To achieve this we will collect necessary information from NWOs, wherever possible through annual financial reporting submissions. This will be similar to the level of information obtained in our 2008 Defined Benefit Pension Questionnaire[6] exercise. NWOs are required to ensure that they keep adequate records to show movements in the pension scheme membership, assets and liabilities attributable to their businesses as distinct from other participants in a group scheme. This requirement will in future include the records required to determine the established deficit as distinct from other amounts of deficit.

Defined benefit schemes - ongoing service contribution costs

3.4. It is difficult to ascertain the comparative efficiency of the pension costs incurred by NWOs because of varying scheme profiles, actuarial assumptions and approaches to funding. NWOs have expected to receive ex post adjustments at the end of each price control period to bring ex ante allowances into line with the payments which they have actually made subject to them being economic and efficient. This has led to some criticism that NWOs have enjoyed a 'pass-through' of these costs.

[6] http://www.ofgem.gov.uk/Networks/Documents1/Pension%20questionnaire%20covering%20letter.pdf

General position

Allowance setting

3.5. In future price controls we will include ongoing service contribution costs as part of the benchmarking of overall employment and/or total costs. This means there will be no specific allowance for ongoing pension costs or the incremental deficits arising following the end of DPCR5, TPCR4 and GDPCR1. However, the NWOs will still be required to separately identify and report these ongoing pension costs in forecast and outturn cost reporting submissions; this is necessary to facilitate other financial analysis, for example, tax allowance calculations. For this purpose, employment costs reported by the NWOs will include the portion of scheme administration and PPF levy costs applicable to the regulated business (although these costs will be subject to separate review because of their nature).

3.6. We will determine the benchmarking methodology at each price control. We expect generally to benchmark NWOs against each other, but we might also benchmark across time or to other sectors of the economy if appropriate or necessary. In this benchmarking we expect to use any normalisation protocols applicable to employment cost benchmarking in the price control.

3.7. In similar fashion, we would expect NWOs to be exposed to carrying the same portion of over expenditure (or allowed to keep the same portion of under expenditure) on ongoing pensions costs as they do for employment costs in general. In DPCR5 this sharing factor for employment costs was set for each DNO group through the information quality incentive (IQI) mechanism, which provides a higher incentive rate for companies whose cost forecasts most closely match Ofgem's. At future reviews we may use different approaches to setting the incentive rates that apply to NWOs. There will be no specific end of period ex post adjustment to actual ongoing pension service costs incurred. However, for GDNs there is a specific ex post adjustment mechanism which will apply at the end of GDPCR1 only[7].

3.8. Early Retirement Deficiency Contributions (ERDC) costs, from 1 April 2004 have been for shareholders to fund and we will therefore exclude them from benchmarking.

3.9. We will also exclude from the benchmarking exercise pension costs attributable to NWO activities not covered by the main price control restrictions. This includes excluded services, de minimis (non-network) business activities and out of area network activities and in the case of electricity distribution, distributed generation, metering and connections and additionally, in transmission, LNG storage and meter reading.

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[7] In the particular circumstances of GDPCR1, this approach was viewed as a way of encouraging and sharing efficiency savings.

3.10. We consider the benchmarking approach to be consistent with NWOs agreeing normal contribution rates with trustees which are informed by up to date and forward looking actuarial advice and which address the incremental liabilities being incurred by the scheme in question. The approach recognises the argument that some schemes which include substantial non-regulated members are already subject to commercial pressure to minimise costs. Ultimately, it is the sponsoring employer who is responsible for meeting a scheme's liabilities.

RAV treatment

3.11. Ongoing service pension costs will be modelled as fast or slow money[8] in accordance with the treatment of employment costs, of which they will form a part.

DPCR5 treatment

3.12. In DPCR5 we were not in a position to implement the allowance setting approach outlined above and so we set an ongoing pension cost allowance for each DNO based on their forecast expenditure. There will be an ex post adjustment to actual contribution levels in the DPCR6 settlement, subject to DNOs bearing 20 per cent of any over-spend and retaining 50 per cent of any under-spend. This treatment also applies to defined contribution scheme costs and will include an adjustment to the regulatory asset value (RAV) position and in respect of tax allowances to emulate the position as if the ex post allowance had been given at the outset of the DPCR5 period.

3.13. In DPCR5, employment costs associated with business support activities and non-operational capex were modelled as 100 per cent fast money as was the associated portion of ongoing pension costs.

Specific points for the TPCR5 and GDPCR2 price controls

Setting allowances

3.14. In TPCR5, GDPCR2 and future price controls we will treat ongoing service pension costs as a component of overall employment costs (albeit separately identifiable) and consequently include these in the efficiency benchmarking of that group of costs. This will mean that:

- pension costs (as part of employment costs) will be subject to any incentive mechanism applied to employment costs, but there will be no other end of period ex post adjustment,

[8] See Glossary for explanation of fast and slow money

- scheme administration and PPF levy costs will be included in the benchmarking treatment (subject to the costs put forward by NWOs being pro-rated with regard to the attribution between regulated and non-regulated activities), and
- employment costs associated with the provision of non-regulated activities, e.g. excluded services, metering, LNG storage and de minimis business, are not part of base revenue allowances and so the same treatment will automatically apply to their ongoing pension service contribution elements.

3.15. We will consider the specific approach for each price control, but it will involve benchmarking and will be set out in the relevant price control documents. Some aspects of allowance setting may also entail NWO-specific adjustments.

Ex post adjustments from previous price controls

3.16. We will make ex post adjustments for the difference between allowances given in TPCR4 and GDPCR1, in accordance with the respective price control final proposals. In respect of GDPCR1, the true-up applies to any change in the percentage rate of contributions for ongoing pension service costs paid by the GDN.

3.17. Ongoing pension service costs will flow into RAV in the same proportion as other employment costs.

Pension scheme administration and PPF levy costs

3.18. We will include pension scheme administration and PPF levy costs in the overall benchmarking of employment costs or total costs and they will be included in allowed revenues. However, we continue to expect NWOs to minimize these costs and, in respect of the PPF levy, mitigate the risk-based element by addressing their credit worthiness profile. We will keep under review whether it is appropriate to propose any cap on the level of these costs.

Defined benefit schemes - deficit repair costs

Established deficits – regulatory funding commitment

3.19. In our final proposals for DPCR5, we confirmed that the established deficit for each NWO as at the end of the current price control would be funded. The established deficit means the difference between assets and liabilities attributable to pensionable service up to the end of each respective price control period set out below and relating to the regulated business under Pension Principle 2:

- for DNOs – the price control period ending on 31 March 2010,
- for GDNs – the price control period ending on 31 March 2013, and
- for Transmission operators (TOs) – the price control period ending on 31 March 2012.

3.20. We will therefore make equivalent proposals at the end of the TPCR4 and GDPCR1 price controls. This approach is consistent with our Pension Principles and it will achieve fairness between different NWOs and their stakeholders.

3.21. This means that, in accordance with Principle 5, subject to an adjustment for the regulatory fraction, the funding commitment covers:

- Changes in the amount of the deficit at the end of the price control period (for example caused by a fall in the value of stock markets or changes in longevity assumptions) provided that the scheme or schemes have been efficiently managed in accordance with Principle 3 and costs are efficient and economic in accordance with Principle 1, even if there has been an interim period during which a funding surplus has been reported, and
- Conversely, the funding commitment does not cover any element of deficit falling outside the scope of the deficit (e.g. non–regulated activities and bulk transferees) at the end of the price control period (the established deficit) or future service of those employees still active in the scheme after the relevant cut-off date and we will not make any future allowance for such deficit elements, other than through the benchmarking process, i.e. the incremental deficit.

3.22. Any deficit payments that arise as a result of service after the relevant cut-off date will be treated as part of the benchmarked employment costs and subject to the same incentive as employment costs in general.

3.23. For each price control we will make an adjustment for the difference between the pension scheme valuation (e.g. for DNOs, as at 30 September 2009) used as a basis to set allowances and the valuation as at the relevant cut-off date. That adjustment will be made ex post either at the subsequent price control or, where appropriate, the mid-period review.

The regulatory fraction

3.24. The regulatory fraction is an important concept for ascertaining the share of a group scheme's pension costs attributable to a licensee's regulated business (see Pension Principle 2). Going forward, it will be particularly important in deciding the amount of the established deficit referred to above. We will re-confirm NWO regulatory fractions at each price control review or at significant interim events such as a structural change as set out in Pension Principle 2.

3.25. In practice, it is difficult to calculate a regulatory fraction for an NWO which either participates in a group scheme or historically undertook both regulated and non-regulated activities (e.g. the old public electricity suppliers) before separation following the Utilities Act 2000. In particular, this is because historical records may not have been retained or, more likely, it was not necessary to record employees' activities to specific functions for the purpose of accruing their individual pension scheme benefits, assets and liabilities. Consequently, regulatory fractions in the past have been decided on a pragmatic basis using the best available information at each price control.

3.26. Where a scheme covers only the employees of an NWO (and there is no other non-regulated activity), its regulatory fraction may be expected to approach 100 per cent subject to review at each price control. In practice, this applies to very few NWOs.

3.27. Early retirement deficiency contributions (ERDC) related adjustments to the regulatory fraction (and thus the established deficit) exist where the benefits concerned were granted to an NWO's employees prior to 1 April 2004 and full funding of those benefits was not made to the scheme at that time. Post 31 March 2004 all ERDCs are for the shareholders to fund.

3.28. We have established a methodology for reviewing the movement in unfunded ERDCs at each price control so as to establish their effect on the regulatory fraction for the NWOs concerned. This is set out in Pension Principle 6. We will review the position whenever the regulatory fraction is reviewed.

Setting of established deficit repair allowances and deficit repair periods

Establishing the deficit

3.29. As mentioned above, we have committed to funding the repair of established deficits provided that the relevant scheme or schemes' costs are efficient and there has been no material failure of stewardship (i.e. they satisfy Pension Principles 1 and 3) so that the costs of addressing the deficit are not higher than they reasonably need to be. Ex post, all actual deficit costs will be subject to an independent efficiency review.

3.30. We will set allowances on the basis of up to date actuarial valuations of the assets and liabilities attributable to the established deficit. The method of attribution of deficit between established and incremental will be clarified in each price control.

3.31. We will require updated valuations for years between triennial valuations as part of each NWO's annual regulatory reporting. We might additionally need interim valuations to inform price control allowance setting (which may be subject to subsequent adjustment to align them with the end of the current price control period).

Notional deficit repair period

3.32. We consider that a notional deficit repair period of 15 years is appropriate in calculating repair allowances for established deficits going forward, balancing the duties placed on NWOs and pension scheme trustees with affordability for gas and electricity consumers. It also allows more time for the uncertainty to reduce about whether the deficits will diminish as the economy recovers. However, we may need to review this in the circumstances of individual price controls.

3.33. In setting DPCR5 allowances (repair annuities) we used a real rate of return of 2.6 per cent to annuitise the funding over the notional repair period. This addresses the real return on the funds that schemes might have expected to receive if the entire deficit amount had been paid over in one go. This conservatively reflected the highest rate used by DNO co-sponsored schemes. We will review this factor for future price controls.

3.34. At each price control, we will consider the impact on the level of deficit which has resulted from payments made in the preceding price control period and take into account the applicable remaining length of the notional deficit repair period. In some circumstances it might also prove necessary to re-set the deficit repair period if, for example, there were a significant change in the quantum of the established deficit.

RAV treatment

3.35. Any established deficit repair costs[9] will be funded and thus modelled as 'fast money' and will not form part of RAV additions. Ongoing service costs will follow the treatment of underlying employment costs.

3.36. Ex post adjustments to TPCR4 and GDPCR1 will follow the treatment for RAV additions for each control.

Efficiency review and mechanics of ex post adjustment

3.37. At the end of the control period, or in any case no longer than five years[10] after the initial allowance was set, we will appoint experts to carry out an efficiency review. This will review factors such as the assumptions underlying the scheme valuation, the scheme's membership profile, and stated investment strategy to determine whether the approach to a company's pension deficit repair is reasonable and efficient. This will allow us to consider whether the full remaining amount of established deficit should be funded by future revenue allowances. It will also assist us in assessing any accelerated repair payments made by NWOs. Where the review indicates that the company's pension costs may be inefficient this will trigger a more in-depth analysis. Where outturn costs are below forecasts, this will determine whether and how much of any efficiency savings the company should retain. If outturn costs are higher than the allowances, this will determine how much of any overspend the company should fund.

[9] Subject to the efficiency review process
[10] Subject to the outcome of the RPI-X@20 review

3.38. To undertake the efficiency review we will commission GAD (or a similarly skilled organisation) to conduct a high level review, albeit with different terms of reference to the previous review undertaken as part of the review of our Pension Principles. The review will be based as far as possible on information in routine annual regulatory returns.

3.39. At the start of each subsequent price control or where relevant and applicable, at a mid-term review, we will re-set deficit funding allowances based on the methodologies set out above. Any under or over-recovery of efficient pension costs against the allowance in the previous price control as determined above, will be adjusted in future revenues over the remaining years of the initial 15 year funding period and be NPV neutral. For the established deficit, companies will generally only be exposed to funding the timing difference between allowances and their actual deficit repair payments, provided that the efficiency review is passed. However, it should be noted that if accelerated payments meant that the established deficit became negative, the NWO might only be able to recover the 'over-payment' if it could arrange lower ongoing service contribution levels with trustees. Some, or possibly all, of any extra allowance in respect of the accelerated payment is likely to be offset by a claw-back of the over-payment under Pension Principle 1.

3.40. A full efficiency review of historical pension liability costs ex post will be triggered following the high level report, where schemes are gauged to be outside of set parameters. Our first, third and fifth Pension Principles will be applied at this review and are respectively as follows:

- Customers of network monopolies should expect to fund 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,

- 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, and

- In principle, each price control should make allowance for the ex ante cost of providing pension benefits accruing during the period of the price 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.

3.41. If following an efficiency review, we think it is necessary to propose a curtailment of deficit repair funding, we will look to spread the impact across the remaining notional deficit repair period.

3.42. Where an NWO makes deficit repair payments relating to the established deficit in excess of the allowances set at the outset of a price control period we will adjust the position in the modelling of allowances for the subsequent price control period, subject to the efficiency review process referred to above. The balance of deficit repair allowances and the adjustment for the accelerated payment will both be spread over the remainder of the original notional repair period[11].

3.43. The adjustment referred to above would serve to compensate the NWO concerned for the time value of the earlier payment so that the NWO would be held NPV neutral. We would use the same discount rate as was used to annuitise the funding for the notional repair period.

3.44. Where at the time of setting the price control allowances, actual deficit repair outturn costs are not known for the final year(s) of the price control, forecast amounts will be used. These may be subject to our review and revision. In the event that actual costs turn out to be materially different to the estimate, we would expect to alter revenues accordingly. If the difference is not due to genuine efficiencies that could not reasonably have been foreseen at the time the forecast was provided, Ofgem will claw back the benefits of any under-spend relative to the estimate used in these proposals and alter the revenue accordingly.

Stranded Surplus

3.45. A pension scheme surplus can to some extent be regarded as a 'negative deficit'. However, arguably a surplus can only be said to truly arise once a scheme has closed and discharged all of its liabilities.

3.46. Where a surplus position arises during a price control period, there should be some claw-back of ex ante deficit repair allowances as referred to in Pension Principle 1.

Transfers of scheme members

3.47. In accordance with Pension Principle 2, with the exception of whole pension scheme mergers the pension deficits relating to any employees (including protected persons) who are transferred into a NWO will be deemed to be outside the scope of the established deficit for the purposes of the regulatory funding commitment referred to above since it would be expected that transferees' pension rights would be fully funded as part of the transfer transaction.

[11] See example at Table 10.6 in the Electricity Distribution Price Control review Final Proposals – Financial methodologies:
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=372&refer=Networks/ElecDist/PriceCntrls/DPCR5

Buy-ins and buy-outs

3.48. These currently fall within the scope of Pension Principles 1, 2 and 5. Buy-ins and buy-outs are effectively a de-risking of future liabilities. It is necessary to determine how such de-risking should be funded, to facilitate efficient management of the schemes and to remove uncertainty as to the regulatory 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 deficit repair period that is used in setting ex ante allowances. We will deal with these, if they occur, applying the existing Pension Principles on a case-by-case basis.

Specific points for the TPCR5 and GDPCR2 price controls

3.49. The GDNs have regulatory fractions close to 100 per cent subject to an adjustment for metering activities, apart from those licences held by National Grid Gas (NGG).

3.50. The non-NGG group GDNs make deficit repair contributions to the NGG group scheme trustees in respect of elements of the deficit attributable to pensioners and deferred pensioners who were not transferred to the new GDN schemes when those businesses were sold by NGG in 2005. These will continue to be treated as pass-through costs. However, the level of those costs will be subject to the review of the NGG group scheme's efficiency as referred to above.

Defined Contribution (DC) Pension Schemes

3.51. The Pension Principles are particularly relevant to DB scheme costs. Benchmarking will include costs relating to DC schemes, as will any ex post adjustment or sharing of under/over-expenditure against ex ante allowances, where this is specifically provided for at a price control. As we do not assess DC scheme costs by reference to the scheme itself, in practice we do not have to consider Pension 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, Pension 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.

Price control tax treatment of pension costs

3.52. Tax legislation relating to the deductibility of and the treatment of ongoing pension costs and deficits have changed over the past few years. 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 will be modelled as incurred in the entity including pension costs.

3.53. We model the cash costs of pensions as deductible in accordance with legislation, currently at 100 per cent of the cash payment made to the pension schemes. This is subject to the irregular payment rules, which spread the relief over more than one year for significant increases. We will apply 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.

3.54. Where an ex post adjustment is applied in respect of a divergence of payments from allowances, the adjustment will usually be applied so that the tax allowance position emulates the one which would have existed if the ex post adjustment amount had been included in the original allowances. In the longer term, such adjustments will only be applicable to established deficit repair payments.

4. Exceptional events

Corporate transactions

4.1. We will consider the price control pension costs implications of any corporate transactions giving rise to a structural change of a pension scheme on a case-by-case basis in accordance with Pension Principle 2. We will normally make any requisite allowance adjustments in the following price control settlement. However, exceptionally, we might need to re-open an extant price control.

4.2. We would expect NWOs to apprise us of prospective business sales, purchases or mergers at the earliest opportunity to discuss the potential impact on the price control treatment.

4.3. Transactions of this nature are usually complex and may be affected by legislative provisions including those relating to the position of employees and their pension rights. From a pensions perspective they are likely to involve scheme trustees and possibly the Pensions Regulator as well as Ofgem.

Financial Distress

4.4. We have set out in previous publications the arrangements we have for responding in the event that an NWO experiences financial distress. We are presently conducting a review of the ring fence conditions in NWO licences. In extremis, network businesses could be affected by insolvency proceedings and an NWO could be subject to an energy administration order[12].

4.5. If such a case arose, we would have to consider the price control position as regards the funding of pension costs in the particular circumstances, liaising with other key stakeholders. It is not possible to set out the exact treatment which would be applied because of the legal implications and complexities which would be involved. However, the following points can be made:

- The price control treatment of pension costs would continue to be addressed in accordance with the Pension Principles set out in this document; and
- The regulatory funding commitment in respect of established deficit repair would not necessarily apply after an NWO had become subject to an energy administration order. This would depend on the particular circumstances of each case and how a NWO evolves or comes out of energy administration.

[12] In this context NWO refers to the licensed company which is a protected energy company within the meaning of chapter 3 of part 3 of the Energy Act 2004

Appendices

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Appendix 1 – Post DPCR4 Price Control Pension Principles

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.

1.1. 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, unless inappropriate, benchmark total employment costs, to ensure companies have correct incentives to manage their costs, including pension costs, efficiently.

Pension administration costs

1.2. We will standardise 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.

1.3. These costs form part of the ongoing pension costs subject to the specific sharing factor in DPCR5 and at subsequent controls, the IQI incentive regime.

Pension Protection Fund Levy

1.4. 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.

1.5. These costs form part of the ongoing pension costs subject to the specific sharing factor in DPCR5 and at subsequent controls, the IQI incentive regime.

Stranded surplus

1.6. In the event that a surplus arises (i.e. assets exceed the full buy-out cost of accrued liabilities) it is the 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.

1.7. We will monitor each scheme's position on an annual basis. If a scheme were in surplus for a given period, we consider it is a reasonable expectation for symmetry in the treatment for funding of deficits. We would therefore expect to share the benefit across members and consumers. 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 a case-by-case basis.

Buy-ins and buy-outs of pension schemes liabilities

1.8. These currently fall within the scope of Principles 1, 2 and 5. Buy-ins and buy-outs are effectively a de-risking of future liabilities. It is necessary to determine how such de-risking should be funded, to facilitate efficient management of the schemes and to remove uncertainty as to the regulatory 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 deficit repair period that is used in setting ex ante allowances. We will deal with these, if they occur, applying the existing Pension 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.

1.9. 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 business and excluded services (which are self-financing) in the context of a transportation and/ or distribution price control. 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.

1.10. At DPCR4, there was a general assumption of a 20 per cent disallowance for non-regulated activities for most licensees. For DPCR5, this split was retained as a starting point. At TPCR4, only the proportion of ongoing contributions and existing deficit that related to unregulated activities was disallowed. In GDPCR1, a small adjustment was made in respect of pensions relating to the metering business.

1.11. 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.

1.12. 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.

1.13. The non-regulated component of pension liabilities should logically reduce over time in a closed pension scheme for a predominantly wires or pipes only business. Thus, the allowed regulated fraction should increase. This will be calculated by determining the liabilities attributed to the active scheme members in the regulated business and the movement from the position determined at the previous price control. For DNOs this will over time, move the fraction to their actual attribution (where supported by the necessary records) from the 80:20 pragmatic split at DPCR4. The methodology is set out in **Chapter 10 of the Financial Methodologies document (ref 148/09)**. This element of the regulatory fractions is only reset at the start of each price control period for setting ex ante allowances. It does not apply in the calculation of any ex post adjustment. This mechanism is not applicable in gas distribution networks as their schemes only had active members transferred from NGG.

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. For gas distribution and the electricity and gas transmission schemes the basis at TPCR4 and GDPCR1 will continue, subject to review, and the effects arising from any structural changes and/or bulk transfers.

Bulk transfers

1.17. 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. Bulk transfers in to a scheme have to be approved by trustees and as specified by the Pensions Regulator (TPR), have to be fully funded (in all but exceptional circumstances). 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". It also states that "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”. We consider that movements in deficits arising from bulk transfers that result from corporate transactions, whether fully funded or not, should be a risk for shareholders and not consumers. This applies even where the transferred protected person’s pension liability is underfunded where it arises from a corporate transaction.

1.18. Whilst transfers in may be accepted and some may include protected persons who may or may not be considered part of the regulated activities, it is considered that in order to control future deficits shareholders, not consumers, should fund any increase related to the transferees at future price controls.

1.19. This clarification covers only bulk transfers where individuals or groups of individuals (but not whole, or substantially, whole schemes) are transferred as part of a smaller transaction to acquire an activity rather than a licensee. A full merger between two existing DB schemes as a result of a corporate transaction is therefore excluded and will be dealt as a structural change (see above).

1.20. We cannot predict whether this treatment will be equitable to all situations. If we are satisfied that there are exceptional circumstances, we retain the option to deal with these on a case-by-case basis.

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.

1.21. 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 these Pension 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 been 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.

1.22. 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 and an efficiency review. 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.

1.23. It is recognised 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 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.

1.24. 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. We would expect and may request that, where the timing of triennial valuations does not align with price control periods, companies 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.

1.25. 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 may adjust the recommended funding rate for the purposes of setting the price control.

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.

1.26. Typically, actuarial valuations of pension funds are carried out triennially. In contrast, price controls are typically set for periods of five years, following the outcome of the RPI-X@20 review this may be longer. 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 2004 requirement for annual valuations it is possible that individual or scheme specific events may bring forward valuation dates.

1.27. In our decision for DPCR5 and subsequent reviews, we have introduced a trigger mechanism, being an independent efficiency review, for clarifying how and when we may either true up to actual cash costs or subject them to an in-depth review to assess the quantum of costs that we would true up ex post. We also stated that funding of any incremental deficit in excess of the established deficit at the end of the DPCR5, TPCR4 and GDPCR1 price controls would be subject to the same incentive mechanism as all other costs (including ongoing pension service costs). At present, this is generally the information quality incentive as calibrated for individual price controls. In principle we will apply the following guidelines, which are mainly but not exclusively applicable to the open price controls- DPCR5, TPCR4 and GDPCR1:

1. We will log up the cumulative effect and pass the impact through to consumers when setting the price control at subsequent reviews subject to determining that such costs comply with Principle 1 being both economic and efficient and subject to any incentive mechanism applicable at a particular control.

2. In assessing the quantum, adjustments may be made where the costs are not determined to be both economic and efficient in line with Principle 1.

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 over the same period.

4. To the extent that actual contributions in any period fall short of or exceed the assumed contribution, these will be dealt with in accordance with the appropriate incentive mechanism.

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, this will be reviewed 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. Subject to any applicable incentive mechanism, 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. This does not apply to DPCR5, because there are specific sharing factors.

9. Subject to any applicable incentive mechanism, the difference between the ex ante allowances for pension administration costs and the PPF levy and the actual cash funding costs will be adjusted at the next price control. This will be subject to NWOs demonstrating that the costs are economic and efficient, e.g. that steps have been taken to mitigate, in particular, the risk-based element of the PPF levy and are comparable with appropriate comparators.

10. As noted under Principle 2, 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

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

1.29. 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 notional 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.

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

1.31. 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.

1.32. 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 the 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), and
    - 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%				

Appendix 2 – 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 (such as the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Acts of 2004, 2008 and 2010) as well as arising from directly effective European Community legislation.

1.3. References to the Gas Act and the Electricity Act in this appendix are to Part 1 of those Acts.[13] 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.[14]

1.4. The Authority’s principal objective is to protect the interests of existing and future consumers in relation to gas conveyed through pipes and electricity conveyed by distribution or transmission systems. The interests of such consumers are their interests taken as a whole, including their interests in the reduction of greenhouse gases and in the security of the supply of gas and electricity to them.

1.5. The Authority is generally required to carry out its functions in the manner it considers is best calculated to further the principal objective, wherever appropriate by promoting effective competition between persons engaged in, or commercial activities connected with,

- the shipping, transportation or supply of gas conveyed through pipes;
- the generation, transmission, distribution or supply of electricity;
- the provision or use of electricity interconnectors.

1.6. Before deciding to carry out its functions in a particular manner with a view to promoting competition, the Authority will have to consider the extent to which the interests of consumers would be protected by that manner of carrying out those functions and whether there is any other manner (whether or not it would promote competition) in

[13] Entitled “Gas Supply” and “Electricity Supply” respectively.
[14] 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.

which the Authority could carry out those functions which would better protect those interests.

1.7. In performing these duties, the Authority must 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[15]; and
- the need to contribute to the achievement of sustainable development.

1.8. In performing these duties, the Authority must have regard to the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.[16]

1.9. 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[17] 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,

and shall, in carrying out those functions, have regard to the effect on the environment.

1.10. In carrying out these functions the Authority must also have regard to:

- 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.

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[15] 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 Acts in the case of Electricity Act functions.
[16] The Authority may have regard to other descriptions of consumers.
[17] Or persons authorised by exemptions to carry on any activity.

1.11. The Authority may, in carrying out a function under the Gas Act and the Electricity Act, have regard to any interests of consumers in relation to communications services and electronic communications apparatus or to water or sewerage services (within the meaning of the Water Industry Act 1991), which are affected by the carrying out of that function.

1.12. 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[18] 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.

[18] Council Regulation (EC) 1/2003.

Appendix 3 - Glossary

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

DNO – Electricity distribution network operator

One of the 14 ex-public electricity suppliers which holds an electricity distribution licence and which has a geographically defined distribution services area.

DPCR5

Distribution Price Control Review 5 - the price control regime for the 14 incumbent electricity distributors applicable for the period from 1 April 2010 to 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.

Established deficit

The difference between assets and liabilities attributable to pensionable service up to the end of each respective price control period set out below and relating to the regulated business under Pension Principle 2:

- for DNOs – the price control period ending on 31 March 2010
- for GDNs – the price control period ending on 31 March 2013
- for Transmission operators (TOs) – the price control period ending on 31 March 2012

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 (see also Slow money)

The portion of allowed expenditure for a network licensee which does not pass into RAV and which is therefore allowed to be recovered in the year in which the cost is deemed to be incurred.

G

GAD – Government Actuary's Department

An actuarial consultancy organisation within the UK public sector.

GDN – Gas distribution network operator

One of the five companies which holds a gas transporters licence referring to a geographically defined distribution services area. National Grid Gas plc hold a licence which covers four distribution services areas and also holds a gas transporters licence in respect of its operation of the national gas transmission system.

GDPCR2

The next price control applicable to Gas transporters (distributors), expected to run from 1 April 2013.

I

Incremental deficits

That deficit relating to the liability created by pensionable service (and attributable assets) after the point at which the pensionable service relating to the established deficit has been fixed.

Information Quality Incentive (IQI)

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

N

NWO

Network Operator – one of the incumbent gas or electricity transmission and/or distribution licensees in Great Britain.

P

Pass through (of costs)

Costs for which NWOs 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 PPF levels of compensation.

PPF Levy

The PPF is financed by a levy on schemes, this levy has a number of constituent elements including 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").

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 at 20

Ofgem's project to review the workings of the current approach to regulating energy networks in Great Britain and develop future policy recommendations

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(s). It effectively underwrites the risks that the scheme is exposed to, including existing underfunding, longevity, investment and inflation.

Slow money (see also Fast money)

The portion of allowed expenditure for a network licensee which passes into RAV and in respect of which a return is given and depreciation allowed. The annual return and depreciation allowance form part of the NWO’s revenue allowance for the year concerned.

T

TO – Transmission Operator

One of the three companies holding electricity transmission licences in Great Britain:

- National Grid Electricity Transmission plc,
- SP Transmission Ltd,
- Scottish Hydro Electric Transmission Ltd,

and National Grid Gas plc in its role as the gas transmission licensee for Great Britain.

Transmission Price Control Review (TPCR4)

The current price control applicable to the four Gas and Electricity transmission NWOs, which runs from 1 April 2007 to 31 March 2012.

TPCR4 adapted rollover

A one year roll-over of the current transmission price control (TPCR4) for the period from 1 April 2012 to 31 March 2013 to enable TPCR5 to reflect fully the conclusions of the RPI-X@20 project and other relevant developments.

TPCR5

The next price control applicable to the four Gas and Electricity transmission NWOs, expected to run from 1 April 2013.

TPR

The Pensions Regulator, established under the Pensions Act 2004.

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.