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Distribution Network Operators, Generators, Transmission Owners, Electricity Suppliers, Pension scheme trustees, Consumers, and their representatives; and other interested parties

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**Provisional revised pension allowance values for RIIO network operators and 2023 reasonableness review**

In this letter we set out provisional pension allowance values for the RIIO network operators' (NWOs') pension allowances and our recommendations to the NWOs for changes they may want to adopt before the next reasonableness review in 2026. The proposed revised allowances would reduce revenue, across all companies, over the next three years by an annual average of £344 million. On a triennial basis, the Authority[1] reviews the pension allowances that RIIO NWOs can recover as part of their regulated revenue under the price controls, which consumers fund through their energy bills. Our review looks at the latest valuations and the governance arrangements the NWOs have in place.

Appendix 1 contains the provisional revised allowances that would take effect from 1 April 2024. Appendix 2 contains the total average annual pension allowance for the next three years which would reduce from a net allowance figure of £334 million to net recovery position of £10 million, a reduction of £344 million per year.[2] This reduction is a result of the latest actuarial valuations which show that the funding position of all but one scheme has improved since the last valuation with the majority now over 90% funded and five schemes in surplus. The main reason for this improvement is strong investment performance on return-seeking assets and wider market events, as well as the impact of higher contributions being made into pension schemes.

In our review of the NWOs' submissions, we considered the following:

- What changes, if any, should be made to the NWOs' proposed base pension scheme established deficit (PSEDs) allowances and payment history;
- Whether to apply any adjustment factors; and
- Whether to set out any good practice recommendations for the NWOs to adopt before the next reasonableness review.

Based on our review we propose to make no changes to the base PSED or pension payment history (PPH) proposed by the NWOs. Allowances for most NWOs have reduced below zero, reflecting the transition towards fully funded schemes and over payments made that are recovered as part of the PPH adjustment. Further, we do not consider the need to apply an adjustment factor to any of the NWOs pension allowances. We set out our recommendations below.

[1] The Authority is the Gas and Electricity Markets Authority. The terms 'the Authority', 'Ofgem', 'we' and 'us' are used interchangeably in this letter.
[2] 2020-21 price base

## Background

The defined benefit (DB) pension schemes sponsored by most NWOs have their roots in employee remuneration packages that existed before the privatisation of the energy networks between 1986 and 1991. All NWOs' DB pension schemes are now closed to new members, although most continue to accrue obligations in respect of pensionable service of existing members. A small number are closed to all future accrual. NWOs have a current DB pension obligation of £42.3 billion, with £42.0 billion in assets, leaving a deficit of £0.3 billion.[3] Assets that are held by the schemes to fund those obligations remain substantial relative to the size of the businesses themselves. This obligation will continue for several decades, although the liability will diminish as the number of members receiving pension payments reduces and schemes move towards eventual wind-up. In addition, the benefits available to employees of electricity networks at the time of privatisation are subject to protected persons legislation.[4]

For DB schemes, funding requirements for accrued obligations are highly uncertain because factors such as fund investment returns and longevity assumptions can vary. Contributions made by the employer (and, where appropriate, the member) at the time of a member's pensionable service are calibrated to cover the estimated obligation accrued from that service. However, market conditions, general changes in longevity and other developments can render those initial assumptions either too cautious or not cautious enough. As a result, scheme surpluses or deficits can arise.

## Reasonableness review and revision of pension allowances

The financial handbook for each sector sets out the timetable for the reasonableness review and the methodology for revising pension allowance values.

We appointed the Government Actuary's Department (GAD) to review and produce a report of the NWOs' submissions. We asked GAD to provide a high-level view on the pension valuations methodology and assumptions, building on its reviews from 2017 and 2020.

We also asked for GAD's view on how the NWOs have considered the interests of consumers to inform the NWOs' participation in the governance of their pension schemes. We will publish GAD's final report when we conclude the reasonableness review in November.[5]

GAD has provided us with a draft summary report, its provisional findings are as follows:

- Overall, GAD has no substantive concerns with the changes to NWOs' benefit design, investment strategy and method and assumptions used to determine defined benefit pension costs at the most recent valuations. Where there have been changes, it did not consider these unreasonable.

- GAD identified that a number of the schemes had applied discretionary pension benefit increases as a result of recent high inflation, with a range of increases being applied in practice. Some NWOs have commented on their approach to discretionary increases. To the extent that the pension scheme rules included a provision to cap 2023 pension increases relative to full RPI (which exceeded 12%), GAD suggested that Ofgem may wish to consider the increases awarded and associated cost implications for consumers. A range of increases was applied in practice; the specific circumstances will vary between NWOs and scheme arrangements. For many defined benefit pension schemes, benefits

[3] Nominal price base
[4] The Electricity (Protected Persons) (England and Wales) Pension Regulations 1990 (SI 1990/346).
[5] We will share a draft of the final report with NWOs in advance of publication.

increases are linked to the inflation rate. Therefore, higher levels of inflation increase the cost of providing benefits to members. Capped increases apply in many schemes, for example, paying the lower of inflation or 5% p.a, or 2.5% p.a. This will reduce the additional benefit cost of high inflation (relative to an uncapped increase). However, as pension increases can lag notably below the current level of inflation, trustees may wish to apply discretionary increases to members to bridge the gap.

- GAD found that many of the schemes continue to de-risk – schemes have generally reduced the proportion of assets in return seeking assets and increased hedging of interest rate and inflation risk. Reducing risk reduces volatility in asset values but at the expense of increasing expected costs.

- GAD noted that not all NWOs are paying sufficient employer contributions to meet the expected cost of benefits accruing on the valuation assumptions, including for schemes in deficit. This could lead to a deficit emerging over time unless factors such as investment outperformance or changes in valuation assumptions counteract the underpayment at the next valuation.

- All companies have been able to describe examples of actions which they consider to be evidence of them acting in the consumer interest, including:
    - Commissioning analysis which considered consumer interests
    - Negotiating with trustees on valuation concessions
    - Engaging with trustees on investment strategy
    - Managing the liabilities so that consumers are not unduly exposed to higher costs.

- GAD noted that some companies had cited more examples than others, although it is recognised that scheme circumstances vary and views on how the consumer is best served may also differ.

- All NWOs state that they have:
    - Governance arrangements, which include collaborative working with trustees; and
    - Actively represented consumers in discussions with trustees.

- Some also have:
    - Provided training to trustees on consumer interests or stranded surplus
    - Collaborated on the appointment of new chairs of the trustee board with professional and industry experience; and
    - Requested advisors carry out analysis on, or explicitly consider, consumer interests.

- Several NWOs stated that they had worked with the trustees to develop an investment strategy that considers consumer interests. These include:
    - increasing hedging to reduce unrewarded risk
    - reducing volatility and/or de-risking as funding levels improve
    - maintaining returns in the medium term, balanced against additional risks
    - increased asset diversification; and
    - reducing (management and adviser) costs.

- Several schemes have considered, or implemented, a pensioner buy-in or longevity hedge to reduce risk. The efficiency of this approach will depend on the cost agreed.

- Almost all NWOs have provided evidence of liability management. These include:
    - Pension increase exchange (PIE) exercises
    - Early retirement, voluntary redundancy, and/or flexible retirement options

  - Transfer exercises; and
  - Pension increase engagement with trustees.

- All NWOs state that a 'trapped' or 'stranded' surplus is not in the consumers' interests and they give examples of how this has been managed, including that they have:
  - contribution triggers
  - valuation outcomes (including negotiation over the length of recovery plans)
  - intra-valuation outcomes (e.g. deferring previously agreed Deficit Recovery Contributions (DRCs) where a surplus has since emerged)
  - liability management exercises

- As schemes reach full-funding / move into surplus, several NWOs have established expense reserves from which to meet administration and adviser fees, that would otherwise be paid directly from the NWO (and hence by customers). GAD considers the introduction of expense reserves to represent a reasonable approach and application within the scheme, provided expenses are managed efficiently and represent value for money.

- Schemes' valuation outcomes led to differing recovery plans for schemes in deficit, ranging from reduced deficit recovery contributions, extended recovery periods, or maintained contributions, while reducing the recovery period, with only one scheme increasing contributions.

- GAD noted that one scheme had excluded Asset Backed Contributions (ABCs) from the Technical Provisions balance sheet, and that a materially smaller deficit (resulting in lower DRCs) would have been declared if these were included. We intend to seek further understanding of this approach.

**Managing pension surplus**

A surplus arises when the assets in a scheme are more than enough to fund the scheme's liabilities and a surplus becomes 'trapped' or 'stranded' if there is not enough flexibility in the scheme's funding to easily realise the surplus value, for example by reducing the level of ongoing contributions for existing members still in service (a contribution holiday).

There is a strong interaction between the risk of a stranded surplus and the approach to other risks in the schemes. Avoiding the possibility of a stranded surplus would effectively cut off some of the potential upside from other risks, which would point towards lower risk strategies as a scheme becomes more fully funded.

As NWOs' schemes approach full funding this is becoming more of a consideration when setting investment and funding strategies.

One of the objectives behind our policy is to protect the consumer interest by encouraging strategies that ensure any over-funding can be returned to consumers, where appropriate, and that minimise the risk of a surplus being unrecoverable for consumers or being used. An example would be to de-risk the scheme in a way that would not otherwise be in the consumer interest (noting schemes should have appropriate regard to the strong sponsor covenant).[6] Strategies may include careful management of deficit funding, the use of asset backed funding arrangements and the use of pension contribution holidays, especially when a scheme still has a significant number of active members.

As part of future reasonableness reviews, we will continue to review any established surplus to identify whether a more detailed review is required. This more detailed review will occur as part of the close-out of RIIO-2, using the latest information available at that time. The review would take into account the mitigating actions a NWO has put in place

[6] The extent to which trustees can rely on contributions from the sponsor given its willingness and ability to pay

to manage an unnecessary surplus, prevailing and forecast market conditions, the impact of any pension payment holidays (including the timing of those holidays) and the materiality of the surplus. If the review concludes an adjustment is required, it will be applied as part of the close-out of RIIO-2.We note that four pension schemes are reporting material surplus (Cadent- £101m, NGG - £27m, SGNPS - £37m and SHEPS - £264m) and we may consider it appropriate that we request further information to understand why these schemes are in surplus. The existence of a surplus does not necessarily mean consumers have overpaid, for example, an efficiently incurred surplus can be effectively used to de-risk scheme funding in a way that reduces the likelihood of consumers needing to fund future deficits. Surpluses can come and go as a result of small capital market fluctuations and schemes have typically deployed high hedging-type strategies to minimise their downside risk, however, will still be exposed to adverse experience.

**De-risking**

One of the key dimensions of pension strategy is the approach to risk. In large part, this requires an appropriate investment portfolio: making choices between assets with higher expected returns and risk, or assets with lower expected returns and risk. It is also about mitigating, hedging or otherwise managing risk on the liability side, for example by hedging against longevity uncertainty.

As schemes mature, it is conventional in company-funded schemes to adopt lower risk strategies, but the level of risk is judgmental and there are trade-offs between risk and return.

Several companies have noted de-risking as a strategy to avoid stranded surpluses, as it reduces the likelihood of any surplus. This may not always be in the consumer interest as a lower risk investment strategy is expected to yield lower returns in the longer term and therefore may increase the contributions required (hence increasing cost to consumers).

One of the challenges for NWOs is to interpret the continued consumers' interests in managing these trade-offs, and to avoid a stranded surplus. We will expect that NWOs continue to demonstrate what they are doing to avoid any stranded surplus and explain their approach to the relevant risks accordingly.

**NWOs not paying sufficient employer contributions**

We note that not all NWOs are paying sufficient employer contributions to meet expected cost of benefits accruing on the valuation assumptions, including some schemes in deficit. This could lead to a deficit emerging over time unless offset by investment outperformance and/or changes in valuation assumptions at the next valuation.

We will seek further understanding of why some NWOs are paying lower contributions, and assurances that their approach is consistent with the Pension Principles and that future consumers are not exposed to an unnecessary risk of a deficit emerging.

**Discretionary increases**

We note that some NWOs have agreed discretionary pension benefit increases of above 5%, again we will seek an understanding of how this is consistent with the Pension Principles and considered the interests of consumers.

**Acquisition of WPDESPS and CNESPS by National Grid**

Since the 2020 reasonableness review, National Grid have acquired Western Power Grid and is now responsible for WPDESPS and CNESPS. This has delayed their formal valuation submission. Their valuation reports have not been finalised at the time information was provided for the review, although the statutory deadline for completing the valuations had passed. Our review has been based on the draft valuations report submitted. We understand this is based on initial proposals and could be subject to change. We will consider in detail any changes between the draft and final valuation reports, and in particular any impact these may have on the pension costs borne by National Grid, and therefore whether agreed allowances remain appropriate.

**Proposed pension policy review**

Ofgem last reviewed the policy in 2017[7], this clarified the nature of our commitment to provide funding for PSEDs of NWOs subject to price control under our RIIO regimes. The majority of schemes are now over 90% funded, with some schemes in surplus. We consider that this may be an appropriate time to carry out a review of the policy for funding PSED and who should bear that risk in the future.

**Next steps**

Appendix 1 sets out our proposed allowances, and Appendix 2 shows the current established deficit and a comparison against the previous reasonableness review.

We welcome any responses to the proposals outlined in this letter and any representations on the proposed revision of values. These should be made on or before 27 October 2023 by email to david.simpson@ofgem.gov.uk.

We will conclude the reasonableness review in November 2023. The revised allowances will be reflected as part of the Annual Iteration Process for each sector.

Yours faithfully,

**Mick Watson**
**Chief Financial Advisor, Deputy Director**

[7] https://www.ofgem.gov.uk/publications/decision-ofgems-policy-funding-pension-scheme-established-deficits

## Appendix 1 – Summary and analysis of revised pension allowances

**Table 1.1 - Revised pension allowances RIIO -ED2 (£m, 2020-21 prices)**

| Licensee | Description | Licence term | 2025 | 2026 | 2027 | Average 2025-27 |
|---|---|---|---|---|---|---|
| ENWL | PSED Revenue Allowance | EDE | (7.3) | - | - | (2.4) |
| NPgN | PSED Revenue Allowance | EDE | (31.9) | - | - | (10.6) |
| NPgY | PSED Revenue Allowance | EDE | (15.4) | - | - | (5.1) |
| WMID | PSED Revenue Allowance | EDE | (5.9) | (5.9) | (5.9) | (5.9) |
| EMID | PSED Revenue Allowance | EDE | (5.5) | (5.5) | (5.5) | (5.5) |
| SWALES | PSED Revenue Allowance | EDE | (0.5) | (0.5) | (0.5) | (0.5) |
| SWEST | PSED Revenue Allowance | EDE | 0.5 | 0.5 | 0.5 | 0.5 |
| LPN | PSED Revenue Allowance | EDE | (4.8) | (4.8) | (4.8) | (4.8) |
| SPN | PSED Revenue Allowance | EDE | (3.5) | (3.5) | (3.5) | (3.5) |
| EPN | PSED Revenue Allowance | EDE | 0.2 | 0.2 | 0.2 | 0.2 |
| SPD | PSED Revenue Allowance | EDE | (5.8) | (5.8) | (5.8) | (5.8) |
| SPMW | PSED Revenue Allowance | EDE | 33.3 | 33.3 | 33.3 | 33.3 |
| SSEH | PSED Revenue Allowance | EDE | (4.8) | (4.8) | (4.8) | (4.8) |
| SSES | PSED Revenue Allowance | EDE | (1.0) | (1.0) | (0.5) | (0.8) |

**Table 1.2 - Revised pension allowances RIIO-ET2 (£m, 2018-19 prices)**

| Licensee | Description | Licence term | 2025 | 2026 | 2027 | Average 2025-27 |
|---|---|---|---|---|---|---|
| SHE - Transmission plc | PSED Revenue Allowance | EDE | (0.2) | (0.2) | - | (0.1) |
| SPTL | PSED Revenue Allowance | EDE | (0.0) | (0.0) | (0.0) | (0.0) |
| NGET TO | PSED Revenue Allowance | EDE | (1.2) | (1.2) | (1.2) | (1.2) |
| NGET SO | PSED Revenue Allowance | SOEDE | (0.4) | (0.4) | (0.4) | (0.4) |

**Table 1.3 - Revised pension allowances RIIO-GT2 (£m, 2018-19 prices)**

| Licensee | Description | Licence term | 2025 | 2026 | 2027 | Average 2025-27 |
|---|---|---|---|---|---|---|
| NGGT TO | PSED Revenue Allowance | EDE | (6.5) | (6.5) | (6.4) | (6.5) |
| NGGT SO | PSED Revenue Allowance | SOEDE | (2.7) | (2.7) | (2.7) | (2.7) |

**Table 1.4 - Revised pension allowances RIIO-GD2 (£m, 2018-19 prices)**

| Licensee | Description | Licence term | 2025 | 2026 | 2027 | Average 2025-27 |
|---|---|---|---|---|---|---|
| East | PSED Revenue Allowance | EDE | (3.1) | (3.1) | (3.2) | (3.1) |
| London | PSED Revenue Allowance | EDE | (2.0) | (2.0) | (2.1) | (2.0) |
| North West | PSED Revenue Allowance | EDE | (1.8) | (1.8) | (1.8) | (1.8) |
| West Midlands | PSED Revenue Allowance | EDE | (2.3) | (2.3) | (2.4) | (2.3) |
| Northern | PSED Revenue Allowance | EDE | 17.5 | 17.4 | 8.5 | 14.5 |
| Scotland | PSED Revenue Allowance | EDE | (0.1) | (0.1) | (0.1) | (0.1) |
| Southern | PSED Revenue Allowance | EDE | (0.1) | (0.1) | (0.1) | (0.1) |
| Wales & West | PSED Revenue Allowance | EDE | 12.0 | 12.0 | 12.0 | 12.0 |

Table 1.5 - of which payment history accounts (£m, 2020-21 prices)

| Licensee | Description | Financial handbook term | 2025 | 2026 | 2027 |
|---|---|---|---|---|---|
| ENWL | Payment history | PPH | (7.3) | - | - |
| NPgN | Payment history | PPH | (31.9) | - | - |
| NPgY | Payment history | PPH | (15.4) | - | - |
| WMID | Payment history | PPH | (3.1) | (3.1) | (3.1) |
| EMID | Payment history | PPH | (2.8) | (2.8) | (2.8) |
| SWALES | Payment history | PPH | (1.7) | (1.7) | (1.7) |
| SWEST | Payment history | PPH | (1.9) | (1.9) | (1.9) |
| LPN | Payment history | PPH | (0.6) | (0.6) | (0.6) |
| SPN | Payment history | PPH | (0.3) | (0.3) | (0.3) |
| EPN | Payment history | PPH | 0.2 | 0.2 | 0.2 |
| SPD | Payment history | PPH | (5.8) | (5.8) | (5.8) |
| SPMW | Payment history | PPH | 4.6 | 4.6 | 4.6 |
| SSEH | Payment history | PPH | (4.8) | (4.8) | (4.8) |
| SSES | Payment history | PPH | (8.5) | (8.5) | (1.3) |

Table 1.6 - of which payment history accounts (£m, 2018-19 prices)

| Licensee | Description | Financial handbook term | 2025 | 2026 | 2027 |
|---|---|---|---|---|---|
| SHE - Transmission pl | Payment History | PPH | (0.2) | (0.2) | - |
| SPTL | Payment History | PPH | (0.0) | (0.0) | (0.0) |
| NGET TO | Payment History | PPH | (0.9) | (0.8) | (0.8) |
| NGET SO | Payment History | PPH | (0.3) | (0.3) | (0.3) |

Table 1.7 - of which payment history accounts (£m, 2018-19 prices)

| Licensee | Description | Financial handbook term | 2025 | 2026 | 2027 |
|---|---|---|---|---|---|
| NGGT TO | Payment History | PPH | (6.5) | (6.5) | (6.4) |
| NGGT SO | Payment History | PPH | (2.7) | (2.7) | (2.7) |

Table 1.8 - of which payment history accounts (£m, 2018-19 prices)

| Licensee | Description | Financial handbook term | 2025 | 2026 | 2027 |
|---|---|---|---|---|---|
| East | Payment History | PPH | (3.1) | (3.1) | (3.2) |
| London | Payment History | PPH | (2.0) | (2.0) | (2.1) |
| North West | Payment History | PPH | (1.8) | (1.8) | (1.8) |
| West Midlands | Payment History | PPH | (2.3) | (2.3) | (2.4) |
| Northern | Payment History | PPH | 10.4 | 10.3 | 1.4 |
| Scotland | Payment History | PPH | (0.1) | (0.1) | (0.1) |
| Southern | Payment History | PPH | (0.1) | (0.1) | (0.1) |
| Wales & West | Payment History | PPH | 4.4 | 4.4 | 4.4 |

## Appendix 2 – Summary of proposed Pension Scheme Established Deficit revenue allowances

**Revised allowances following Ofgem 2023 Reasonableness Review (2020 -21 prices)**

| Price Control | Licensee | Licence term | Average 2020 Reasonableness Review (2020-21 prices) | Average 2023 Reasonableness Review (2020-21 prices) | Variance | Variance |
|---|---|---|---|---|---|---|
| | | | £m | £m | £m | Percentage |
| ED1 | ENWL | EDE | 12.2 | (2.4) | (14.6) | -120% |
| | NPgN | EDE | 7.8 | (10.6) | (18.4) | -236% |
| | NPgY | EDE | 3.8 | (5.1) | (8.9) | -235% |
| | WMID | EDE | 37.3 | (5.9) | (43.2) | -116% |
| | EMID | EDE | 39.0 | (5.5) | (44.5) | -114% |
| | SWALES | EDE | 14.6 | (0.5) | (15.1) | -103% |
| | SWEST | EDE | 26.2 | 0.5 | (25.7) | -98% |
| | LPN | EDE | 19.7 | (4.8) | (24.5) | -125% |
| | SPN | EDE | 16.3 | (3.5) | (19.9) | -122% |
| | EPN | EDE | 7.1 | 0.2 | (6.9) | -98% |
| | SPD | EDE | 29.7 | (5.8) | (35.5) | -119% |
| | SPMW | EDE | 31.1 | 33.3 | 2.2 | 7% |
| | SSEH | EDE | (3.2) | (4.8) | (1.5) | 46% |
| | SSES | EDE | 23.3 | (0.8) | (24.1) | -104% |
| | **RIIO-ED2** | | **264.9** | **(15.9)** | (280.7) | -106% |
| ET2 | SHE - Transmission plc | EDE | (1.5) | (0.1) | 1.4 | -93% |
| | SPTL | EDE | 3.2 | (0.0) | (3.2) | -101% |
| | NGET TO | EDE | 26.0 | (1.2) | (27.2) | -105% |
| | **RIIO-ET2** | | **27.7** | **(1.4)** | (29.1) | -105% |
| | **NGET SO** | **SOEDE** | **7.9** | **(0.4)** | (8.3) | -105% |
| GD2 | East | EDE | 9.8 | (3.2) | (13.0) | -133% |
| | London | EDE | 5.7 | (2.1) | (7.9) | -137% |
| | North West | EDE | 5.0 | (1.9) | (6.9) | -137% |
| | West Midlands | EDE | 6.5 | (2.4) | (8.9) | -137% |
| | Northern | EDE | 7.8 | 15.0 | 7.2 | 92% |
| | Scotland | EDE | 0.5 | (0.1) | (0.6) | -120% |
| | Southern | EDE | 0.4 | (0.2) | (0.5) | -140% |
| | Wales & West | EDE | 8.8 | 12.5 | 3.7 | 42% |
| | **RIIO-GD2** | | **44.6** | **17.6** | (27.0) | -61% |
| GT2 | NGGT TO | EDE | (11.5) | (6.7) | 4.7 | -41% |
| | NGGT SO | SOEDE | 0.6 | (2.8) | (3.4) | -541% |
| | **RIIO-GT2** | | **(10.8)** | **(9.5)** | 1.3 | -12% |
| | **Total** | | **334.2** | **(9.6)** | (343.8) | -103% |