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Date: 24 November 2023

Revised pension allowance values and completion of 2023 reasonableness review

On 13 October 2023 we gave Notice¹ of our intention to direct pension allowance values as part of the 2023 reasonableness review for network operators (NWOs). This review determines the revenues that the RIIO network companies can recover to fund their established pension deficits for the next three years. This letter sets out the revised allowances and completes the 2023 reasonableness review. We confirm the recommendations, as set out in the Notice, to the NWOs on changes they may want to adopt before the next reasonableness review in 2026 and highlight two areas where we intend to seek further understanding. Finally, we confirm our intention to carry out a review of the policy for funding Pension Scheme Established Deficits (PSEDs) and who should bear the relevant risk in the future.

As part of the 2023 reasonableness review, 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, and how it has interpreted the consumer interest building on its reviews from 2017 and 2020. A link to GAD's review can be found at Appendix 3.

Summary of GAD's Review

GAD identified that there are several notable changes in investment strategy, the method and assumptions used to determine the NWOs' defined benefit pension costs at the most recent valuations, and some instances of discretionary increases to pensions. It did not have any major concerns, and it is accepted that some changes will occur between valuations.

- Funding position – the funding positions of all but one scheme have improved since the last valuations, with the majority now over 90% funded. Five schemes now have a surplus on their funding basis, where assets exceed the value of benefits promised. The schemes have all provided examples of how they intend to mitigate potential issues related to a stranded surplus.
- Discretionary increases – several schemes have applied discretionary pension benefit increases because of recent high inflation, with a range of increases being applied in practice.
- De-risking – many of the schemes continue to de-risk, reducing the proportion of assets in return-seeking assets and increasing hedging of interest rate and inflation risk.

¹<https://www.ofgem.gov.uk/publications/notice-our-provisional-revised-pension-allowance-values-and-2023-reasonableness-review>

- Employer contributions – some NWOs are paying contributions which are lower than the expected employer cost of benefits accrued, assessed on (prudent) valuation assumptions, including for schemes in deficit.
- Considering consumer interest – all NWOs have been able to describe examples of actions which they consider to be evidence of them acting in the consumer interest.

Managing pension surplus

As NWOs' schemes approach full funding, mitigating the risk of a stranded surplus is becoming more of a consideration when setting investment and funding strategies.

We confirm that 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 will take into account the mitigating actions a NWO has put in place 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 that 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 a material surplus (Cadent- £101m, NGG - £27m, SGNPS - £29m and SHEPS - £268m) and we may consider it appropriate that we request further information to understand why these schemes are in surplus.

NWOs paying employer contributions which are lower than the expected cost of benefits

We will seek further understanding of why some NWOs are paying contributions which are lower than the cost assessed on (prudent) valuation assumptions, 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 or growing. We recognise that there will be circumstances where this approach will be an appropriate method of surplus management.

Discretionary increases

We will seek further understanding of why some NWOs have agreed discretionary pension benefit increases of above 5%, and how this is consistent with the Pension Principles and considered to be in the interests of existing and future consumers.

Proposed pension policy review

Ofgem last reviewed the policy in 2017², this clarified the nature of our commitment to provide funding for PSEDs of NWOs subject to price control under our RIIO regimes. Most 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 PSEDs and who should bear the relevant risk in the future. Our review will consider consumer interests at its heart and will be subject to a full consultation process.

Responses to our Notice

There were eleven responses from the NWOs to our Notice, and these have been published on our website.³ They mainly identified minor errors in the GAD report and the tables set out in the appendices to the Notice letter. These errors have now been corrected, as reflected in the appendices and final GAD report.

² <https://www.ofgem.gov.uk/publications/decision-of-gems-policy-funding-pension-scheme-established-deficits>

³ <https://www.ofgem.gov.uk/publications/notice-our-provisional-revised-pension-allowance-values-and-2023-reasonableness-review>

We received no other responses, and so we have decided to make no further changes to the proposed allowances.

Our decision and completion of the 2023 reasonableness review

Our decision is to revise the pension allowances for each of the three years following this review according to the proposed values set out in the Notice with minor corrections following NWOs' responses. Appendix 1 sets out the revised pension allowances, and Appendix 2 shows a comparison against the previous reasonableness review. Appendix 3 contains the link to GAD's full high-level review.

The revised allowances will be reflected as part of the Annual Iteration Process for each sector.

If you have any queries in relation to this decision, please contact us by email to david.simpson@ofgem.gov.uk.

Yours faithfully,

Mick Watson
Chief Financial Advisor, Deputy Director

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	2028	Average 2025-27
ENWL	PSED Revenue Allowance	EDE	(7.3)	-	-	-	(2.4)
NPqN	PSED Revenue Allowance	EDE	(31.9)	-	-	-	(10.6)
NPqY	PSED Revenue Allowance	EDE	(15.4)	-	-	-	(5.1)
WMID	PSED Revenue Allowance	EDE	(5.9)	(5.9)	(5.9)	(5.7)	(5.9)
EMID	PSED Revenue Allowance	EDE	(5.5)	(5.5)	(5.5)	(5.3)	(5.5)
SWALES	PSED Revenue Allowance	EDE	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)
SWEST	PSED Revenue Allowance	EDE	0.5	0.5	0.5	0.6	0.5
LPN	PSED Revenue Allowance	EDE	(4.8)	(4.8)	(4.8)	(4.6)	(4.8)
SPN	PSED Revenue Allowance	EDE	(3.5)	(3.5)	(3.5)	(3.5)	(3.5)
EPN	PSED Revenue Allowance	EDE	0.2	0.2	0.2	0.0	0.2
SPD	PSED Revenue Allowance	EDE	(5.8)	(5.8)	(5.8)	(5.7)	(5.8)
SPMW	PSED Revenue Allowance	EDE	33.3	33.3	33.3	13.6	33.3
SSEH	PSED Revenue Allowance	EDE	(4.8)	(4.8)	(4.8)	(4.8)	(4.8)
SSES	PSED Revenue Allowance	EDE	(1.0)	(1.0)	(0.5)	0.0	(0.8)

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

Licensee	Description	Licence term	2025	2026	2027	2028	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)	(0.0)
NGET TO	PSED Revenue Allowance	EDE	(1.2)	(1.2)	(1.2)	(4.6)	(1.2)
NGET SO	PSED Revenue Allowance	SOEDE	(0.4)	(0.4)	(0.4)	(1.4)	(0.4)

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

Licensee	Description	Licence term	2025	2026	2027	2028	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	2028	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)	(0.1)
Southern	PSED Revenue Allowance	EDE	(0.1)	(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	2028
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)	(3.0)
EMID	Payment history	PPH	(2.8)	(2.8)	(2.8)	(2.6)
SWALES	Payment history	PPH	(1.7)	(1.7)	(1.7)	(1.6)
SWEST	Payment history	PPH	(1.9)	(1.9)	(1.9)	(1.7)
LPN	Payment history	PPH	(0.6)	(0.6)	(0.6)	(0.3)
SPN	Payment history	PPH	(0.3)	(0.3)	(0.3)	(0.2)
EPN	Payment history	PPH	0.2	0.2	0.2	0.1
SPD	Payment history	PPH	(5.8)	(5.8)	(5.8)	(5.7)
SPMW	Payment history	PPH	4.6	4.6	4.6	4.6
SSEH	Payment history	PPH	(4.8)	(4.8)	(4.8)	(4.8)
SSSES	Payment history	PPH	(8.5)	(8.5)	(1.3)	0.0

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

Licensee	Description	Financial handbook term	2025	2026	2027	2028
SHE - Transmission pl	Payment History	PPH	(0.2)	(0.2)	-	-
SPTL	Payment History	PPH	(0.0)	(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	2028
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	2028
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)	(0.1)
Southern	Payment History	PPH	(0.1)	(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) £m	Average 2023 Reasonableness Review (2020-21 prices) £m	Variance £m	Variance 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)	-100%
	NGET TO	EDE	26.0	(1.2)	(27.2)	-105%
	RIIO-ET2		27.7	(1.4)	(29.0)	-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	(0.1)	(0.5)	-135%
	Wales & West	EDE	8.8	12.5	3.7	42%
	RIIO-GD2		44.6	17.6	(27.0)	-60%
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%

Appendix 3 – GAD’s High-level review of network operator costs

Full report

<https://www.ofgem.gov.uk/publications/revised-pension-allowance-values-and-completion-2023-reasonableness-review>