Government Actuary's Department

2023 Ofgem Pensions Reasonableness review

High-level review of network operators' pension costs

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1. Executive Summary

High-level review of pension costs

We have considered how the methods and assumptions adopted at the most recent actuarial valuations in 2021 or 2022 have changed since the previous valuations. Overall, we have no major concerns with the changes to benefit design, investment strategy and the method and assumptions used to determine the network operators' (NWOs) defined benefit pension costs at the most recent valuations.

To the extent that the pension scheme rules include a provision to cap 2023 pension increases relative to full RPI (which exceeded 12%), Ofgem may wish to consider the increases awarded and associated cost implications for consumers. A range of increases were applied in practice; the specific circumstances will vary between NWOs and scheme arrangements.

1.1 There were several notable changes identified since the last reasonableness review. Given the constantly changing nature of a pension scheme and the wider environment, it is expected that some changes will occur between valuations. The results are given in Section 3 of this report and summarised in Appendix B. The key findings were:

Long-term objective and de-risking

1.2 Many of the schemes continue to de-risk, with three schemes completing a partial or full buy-in since the last review. Schemes have generally reduced the proportion of assets in return-seeking (or "growth") assets and increased hedging of interest rate and inflation risks. Reducing risk reduces volatility in asset values but at the expense of increasing expected costs.

1.3 Most of the schemes have adopted long-term objectives broadly in line with the draft new Scheme Funding Regulations, expected to be in place from 1 April 2024. Two schemes have adopted even more prudent approaches than the anticipated "benchmark" long-term objective. The strategies adopted are generally consistent with trends seen across the pensions industry and are not surprising given the potential changes to the regulatory framework under consultation.

1.4 Given the strength of the sponsor covenant, the NWOs' schemes would be expected to be able to take more risk than other pension schemes. Therefore, sponsors need to ensure they are robustly negotiating concessions and that any de-risking is not implemented over an unduly short timeframe, given the maturity and funding position of their scheme, as this could increase the cost to consumers.

1.5 Ofgem may wish to set out guidance on its preferred long-term risk position which appropriately reflects the consumer interest. Any future policy on funding might consider the long-term strategy for managing a surplus, the pace of de-risking and what actions might be considered a concern.

Funding position

1.6 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.

1.7 The schemes have all provided examples of how they intend to mitigate potential issues related to a stranded surplus (where a scheme is overfunded having benefitted from previous consumer funding, but the emerging surplus cannot readily be used to the benefit of consumers).

Employer contributions

1.8 We have noted that not all NWOs are paying employer contributions consistent with the amount needed to meet the expected cost of benefits accruing on the valuation assumptions. In the absence of favourable performance, a change in assumptions or use of existing surplus, this could lead to a deficit emerging over time. Ofgem may wish to consider this point further from an overall regulatory perspective.

Deficit recovery plan

1.9 A wide range of approaches to the recovery plan have been taken in the context of improving funding positions. Amongst other factors, recovery plan terms have been informed by the funding position and overall level of contributions payable.

Consumer interests

1.10 We have considered the comments provided in the NWO questionnaire responses provided by Ofgem. These describe how the NWOs believe they have interpreted the interest of consumers when engaging with the governance of its pension scheme (including setting investment and risk strategies).

1.11 All companies have been able to describe some examples of actions which they consider to be evidence of them acting in the consumer interest. We note that some companies have cited more examples than others, although it is recognised that scheme circumstances vary and views on how the consumer is best served can also differ.

1.12 It is possible that additional actions could have been explored further by some companies since the last reasonableness review. However, given the scope of this review and the information provided, we are not in a position to identify any actions (or lack thereof) which could indicate that companies have not fully acted in consumers' best interests. Viable ways to represent the consumer interest will depend on individual scheme circumstances and will vary between schemes.

1.13 An overview of the actions taken is given in Section 4 and summarised for each NWO in Appendix C. A more detailed description of the actions cited by each NWO given in Appendix D.

2. Introduction

2.1 This report has been prepared by the Government Actuary's Department (GAD) at the request of the Office of Gas and Electricity Markets (Ofgem). The purpose of this report is to assist Ofgem in its consideration of price control allowances. This report does not represent advice on the appropriate funding of network operators' (NWOs) pension schemes.

2.2 Ofgem is the government regulator for gas and electricity markets in Great Britain whose primary role is to protect consumers now and in the future. Every three years, Ofgem reviews the pension allowances that the NWOs can recover as part of their regulated revenue.

2.3 To help inform Ofgem's review, Ofgem have asked GAD to perform a high-level review of NWOs defined-benefit pension costs. In particular, we have reviewed how the benefit design, investment strategy, as well as methods and assumptions used to determine the pension costs, have changed since GAD's previous review, which concluded in 2020. More details on the review and a discussion of the findings can be found in Section 3. A summary of these results is in Appendix B.

2.4 Further, Ofgem have also asked GAD to review the NWO questionnaire responses which describe how they have interpreted the interest of consumers to inform participation in the governance of pension schemes. An overview of the actions taken is presented in Section 4 of this report, with a more detailed description of the actions cited by each NWO given in Appendix D. The actions of each NWO are summarised in the table in Appendix C.

2.5 The limitations relating to the information contained in this report are outlined in Section 5.

3. High-level review of pension costs

Overall, we have no major concerns with the changes to benefit design, investment strategy and the method and assumptions used to determine the NWOs' defined benefit pension costs at the most recent valuations.

There were, however, several notable changes as outlined below, including:

- a general improvement in funding position with five schemes now in surplus
- increased de-risking

Given the constantly changing nature of a pension scheme and the wider environment, it is expected that some changes will occur between valuations.

It is possible that additional actions could have been explored further by some companies since the last reasonableness review. However, given the scope of this review and the information provided, we are not in a position to identify any actions (or lack thereof) which could indicate that companies have not fully acted in consumers' best interests. Viable ways to represent the consumer interest will depend on individual scheme circumstances and will vary between schemes.

A summary of the changes in funding approach can be found in Appendix B.

Approach to the review

3.1 We have considered how the methods and assumptions adopted at the most recent actuarial valuations in 2021 or 2022 have changed since the previous valuations. For this review we have assumed Ofgem were content with the approach adopted by the NWOs' defined benefit pension schemes at the 2018 or 2019 valuations and have therefore only considered how the relevant methods and assumptions have changed.

3.2 We have carried out this comparison by considering the responses provided in the questionnaires, and the formal documentation from the previous two actuarial valuations, where provided.

3.3 The main areas we have considered in our review are:

- **Funding position:** the difference between the market value of the scheme's assets and the assessed value of the liabilities at the valuation. Funding levels above 100% mean that the scheme has more than enough assets to meet the value of the liabilities as assessed at the date of the valuation.

- **Deficit recovery plan:** sets out level of additional contributions (known as deficit reduction contributions or DRCs) that will be paid to remove the deficit and the period over which the DRCs will be paid (recovery period).

- **Employer cost of accrual and employer contribution rate:** The employer cost of accrual is the employer's share of the contributions required to meet the expected cost of accruing future benefits. The employer contribution rate is the level of contributions actually paid.

- **Benefits:** the more generous the benefits the higher the ultimate cost.
- **Long-term funding objective:** represents the target assets to be held in the scheme, taking into account its long-term plans (when the scheme is in an advanced, mature state). This objective will incorporate the planned long-term investment strategy and how quickly schemes aim to reach this from their current position. This will affect the choice of discount rates used in assessing today's funding position. Adopting a lower risk long-term funding objective could increase the expected cost to fund the scheme. A higher risk long-term funding objective would be expected to increase volatility in funding outcomes.
- **Investment strategy:** this affects investment returns which impact the amount of contributions needed to be paid into the scheme, as well as the choice of discount rate. Investment strategy is typically considered in terms of 'return-seeking assets' (such as equities) and 'matching' assets (such as bonds). Pension schemes typically hold a mixture of return seeking and matching assets, with more mature schemes generally holding a higher proportion of matching assets than less mature schemes.
- **Discount rates:** the lower the discount rate the higher the assessed cost of providing defined benefits as future expected cashflows are discounted back at a lower rate. Discount rates are typically (but not always) expressed relative to the yields available on government bonds (gilts).
- **Any other significant changes apparent from the documentation**

Events

COVID-19

3.4 In March 2020, the COVID-19 outbreak was declared a pandemic by the World Health Organisation. For pension schemes, the consequences spanned their invested assets and the health and well-being of their membership. Similarly, the impact on NWOs' business operations was significant.

3.5 The demographic impacts of the COVID-19 pandemic are still uncertain. In the UK, higher deaths than expected were experienced over the period from 2020 to 2022, driven by the pandemic itself. As a consequence, this may have reduced pension scheme liabilities. The longer-term effects of the pandemic are unclear, but a consensus is being drawn around lower life expectancies than anticipated before the pandemic. These effects will become clearer in the coming years.

3.6 Pension schemes were also impacted by the tumult in investment markets as many countries enacted policy decisions to 'lock down'. Pension scheme assets are typically globally diversified, and were subject to shocks in market values, especially in March 2020. These market shocks largely corrected over the following year. For the majority of the pension schemes sponsored by the NWOs, the market impacts will have largely been resolved by their valuation dates in 2021 and 2022, albeit some additional margins of prudence to reflect wider uncertainty have been utilised (and justified).

High inflation

3.7 Inflation rose sharply in 2022, following the start of the Ukraine war and increases in food and energy costs. The consumer prices index (CPI) peaked at 11.1% p.a. in October 2022 and although this has fallen to 6.7% p.a. in August 2023, inflation remains high at the time of writing, and significantly above the Bank of England's long-term target of 2% p.a.

3.8 For many defined benefit pension schemes, benefits increases are linked to the inflation rate. Therefore, higher levels of inflation increase the cost of providing benefits to members. Capped increases have been applied 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.

3.9 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%), Ofgem may wish to consider the increases awarded and associated cost implications for consumers where such increases have exceeded the relevant cap. A range of increases were applied in practice; the specific circumstances will vary between NWOs and scheme arrangements.

Autumn 2022 LDI event

3.10 Liability-driven investment (LDI) are investments that aim to match a pension scheme's liabilities, so that changes in the value of liabilities are replicated in the value of assets. Long-term index-linked gilts are the closest match for the long-term liabilities of pension schemes, which have benefits linked to inflation. Therefore, LDI strategies typically give exposure to gilts. The LDI investment provides an increased (leveraged) exposure to gilts compared to a direct investment, so that schemes can retain investment in assets that provide higher growth potential.

3.11 Following the "mini-budget" on 23 September 2022, government bond yields rose sharply over just a few days, to over 4% for the first time in over 10 years. LDI providers required schemes to increase the collateral held for the investment. However, many schemes struggled to provide the collateral quickly enough. Consequently, many schemes needed to sell gilts to raise cash, which further reduced the value of gilts and exacerbated the problem.

3.12 On 28 September 2022, the Bank of England pledged to buy long-dated government bonds, which helped to stabilise the market and allowed schemes to manage their LDI positions.

3.13 Generally, schemes have now altered their LDI portfolios to increase their resilience to rising interest rates. Schemes may generally have increased the liquidity of their assets so that additional collateral can be provided more easily in future.

3.14 In April 2023, The Pensions Regulator (TPR) published formal guidance on minimising LDI risk.

3.15 These events took place after the latest valuation of all the NWO schemes and so the impact of the 'LDI event' will not show on the comparison of funding approaches. The

NWO state that their schemes fared relatively well though the LDI event. A range of approaches were adopted to manage their portfolios. For example, some schemes needed to sell assets or take out a short-term loan to meet collateral requirements. Meanwhile, other schemes reduced their hedging levels to reduce collateral requirements. A few schemes were able to maintain the level of hedging without the need to sell assets. The different approaches will reflect varied LDI strategies and levels of liquidity in their investments. Interest rates have risen again recently and overall, based on the information provided, we do not expect that any of the schemes will have experienced seriously detrimental impacts due to the LDI event.

Market volatility

3.16 Financial markets have been notably volatile over recent years, and it is in this context that NWOs agreed their latest actuarial valuations with their pension schemes. Amongst other factors, volatility has been caused by the COVID-19 pandemic, supply chain issues, high inflation, and more recently, the impacts of the war in Ukraine. Central banks have raised base rates to try to control inflation, which has led to a rise in interest rates and market uncertainty has caused fluctuations in the value of stocks and shares. This market volatility affects the value of the assets held by pension schemes, as well as the value of the liabilities (see below).

3.17 Since the NWOs' latest valuations, gilt yields have risen notably. Higher gilt yields reduce the value of liabilities for schemes that set their discount rate with reference to gilt yields. Schemes that are closely hedged will have also seen asset values fall in line with liabilities and will have broadly maintained a similar funding level. However, schemes that are not fully hedged will have seen an improvement in their funding levels. A number of the NWO schemes are not fully hedged against interest rates and their funding levels may have improved, all else being equal.

3.18 The market environment remains uncertain and funding positions at the next valuation may look materially different. The full effects of this will be drawn out at the next review.

Acquisition of WPDESPS and CNESPS by National Grid

3.19 Since the 2020 reasonableness review, National Grid have acquired Western Power Distribution Ltd and is now responsible for WPDESPS and CNESPS. Protracted negotiations with the Trustees has delayed their formal valuation submissions, with their valuation reporting documents not finalised at the time information was provided for the review, although the statutory deadline for completing the valuations had passed. The comments on the changes in funding approaches covered in this section are based on the initial reporting information submitted. We recognise that initial proposals could be subject to change.

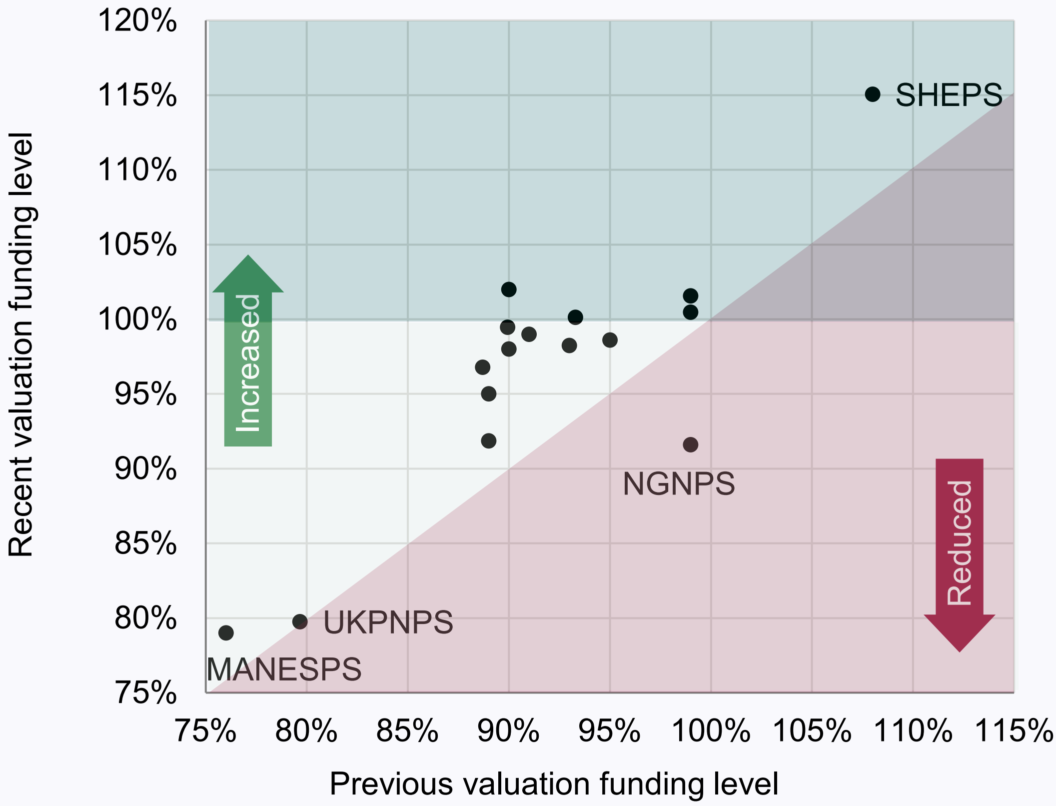
3.20 Ofgem may wish to consider any changes between the draft and final valuation reports, in particular any impact these may have on the pension costs borne by National Grid, and therefore whether agreed allowances remain appropriate.

Comparison of funding approaches

Funding position

3.21 The funding levels at the latest valuation compared with the previous valuation are shown for each scheme in Graph 1 below. The red shaded triangle contains schemes whose funding levels have reduced since the previous valuation. The green shaded section contains schemes whose funding levels have improved. The area shaded in dark green at the top of the graphs shows schemes that are fully funded.

Graph 1: Reported funding level as at previous and most recent valuations



3.22 The funding positions for all but one scheme have improved since the previous valuations. Only NGNPS has experienced a reduction in funding level. NGNPS excluded the value of asset-backed contribution arrangements (ABCs) in its latest valuation, which the Scheme Actuary considered better reflected the funding position of the scheme. Had the ABCs included in the asset value, the scheme would have been almost fully funded, higher than at the previous valuation.

3.23 The majority showed funding levels above 90% at the most recent valuations. Two schemes have a lower funding level of around 80%. The main reason for the improvement in funding level is strong investment performance on return-seeking assets, as well as the impact of extra contributions to reduce the deficit. The schemes are generally fairly well hedged, so that changes in gilts market conditions have a similar on impact liabilities and assets and therefore a modest impact on funding levels.

3.24 Four schemes have a small surplus between 100% and 102% (SGNPS, NGUKPS, CGPS and NPESPS). SHEPS has a significant surplus with funding of 115%, higher than the 108% funding level at the previous valuation.

3.25 These schemes have all provided examples of how they intend to avoid a stranded surplus (where a scheme is overfunded, but the surplus cannot be used to the benefit of the company, and ultimately consumers). These are discussed in Section 4.

Deficit recovery plan

3.26 Where a scheme is in deficit (i.e. the value of assets is lower than the value of liabilities so that the funding level is below 100%), a deficit recovery plan is put in place. This will set out the level of additional contributions, known as deficit reduction contributions or DRCs, that will be paid to increase the assets up to the level of the liabilities, and the period over which the DRCs will be paid (recovery period).

3.27 There appears to be a range of approaches to changes in recovery plans since the previous valuations, as shown in Table 1 below. However, most NWOs stated that compared to the proposal put forward by the Trustees, they aimed to retain the length of the recovery period and reduce contributions.

Table 1: Summary of change in recovery plans since previous valuation

		Recovery period end date		
		Maintained	**Reduced**	**Extended**
Annual deficit contributions	**Broadly Maintained**	WWUPS ENWESPS MANESPS	NGESPS UKPNESPS WPDESPS	UKPNPS
	Reduced	SEESPS SPPS	CNESPS	
	Increased			NGNPS

Note: SHEPS, SGNPS, NGUKPS, CGPS and NPESPS are excluded from this table as they are not making any deficit recovery contributions due to being in funding surplus.

3.28 Five schemes maintained the same end date for the recovery plan. Of these, two schemes reduced DRCs over this same period, consistent with the improved funding position. Three schemes kept broadly the same level of DRCs (WWUPS, MANESPS and ENWESPS).

3.29 Three schemes agreed to remove the deficit earlier with a shorter recovery plan, achieved by continuing to pay broadly the same DRCs. This is consistent with improved funding positions (>5% improvement). We note that an alternative approach may have involved maintaining the recovery period length, with consequent lower DRCs. One scheme reduced the recovery period and the DRCs.

3.30 Two schemes extended the date to repay the deficit. One of these (UKPNPS) broadly maintained the same level of DRCs. The other scheme (NGNPS) increased the DRCs as well as increasing the recovery period, consistent with the deterioration in funding position for NGNPS. We note that ABCs were excluded from the Technical Provisions balance sheet, and a materially smaller deficit would have been declared if these were included. This would have resulted in lower DRCs being needed. Ofgem may wish to consider this treatment further from a regulatory perspective to ensure it is comfortable with the related cost allowances. NGNPS has fully bought in, and the deficit is in respect of the outstanding premiums owed to the insurance company.

3.31 SHEPS, SGNPS, NGUKPS, CGPS and NPESPS showed a funding surplus, and so are not making any deficit recovery contributions.

3.32 NWOs' adopting different recovery periods will result in costs filtering through to consumers at different rates. Costs for customers will increase as recovery periods reduce and DRC payments increase (assuming a fixed deficit), and this has implications for intergenerational fairness between different cohorts of consumers. This is discussed in more in Section 4. I am aware that in 2017 Ofgem published their policy on deficits.

Employer cost of accrual and employer contribution rate

3.33 Schemes with active members receive payments in respect of future accrual via standard employer (and member) contributions.

3.34 Since the last review, NGNPS and WWUPS have closed the scheme to future accrual. Therefore, these schemes no longer have standard employer contributions, although deficit reduction contributions are being paid. SHEPS continues to take a contribution holiday while it remains in surplus. The other four schemes with a modest surplus (SGNPS, NGUKPS, CGPS and NPESPS) continue to receive contributions.

3.35 Many schemes have agreed that employers contribute at a modified contribution rate that is lower than the calculated cost of accrual on the technical provisions basis, including for schemes that are currently 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.

3.36 Table 2 summarises the level of employer contribution rates, and the directional change in rates since the previous valuation, for those schemes receiving standard employer contributions. These contribution rates reflect any modified contribution rate agreed and exclude deficit reduction contributions and. In general, schemes may allow for expenses in different ways in their contributions and some schemes may have changed the way of allowing for such expenses since the previous valuation. These factors may impact on comparisons between scheme contributions.

3.37 Table 2 shows a variety of changes in the standard employer contribution rate since the previous valuation. The 3 schemes that reduced the contribution rate showed only a modest decrease of up to 3% of pay. Conversely, the 6 schemes that increased contributions since the previous valuation had increases ranging from 1% of pay to 8% of pay. There is also a range in contribution rates paid, from around 30% of pay to around 55% of pay.

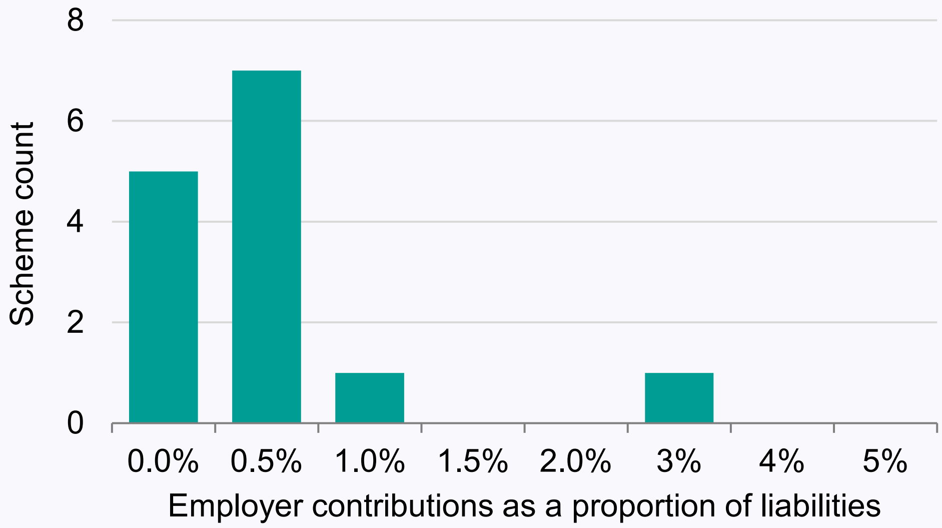
Table 2: Summary of standard employer contribution rates and change since previous valuation

Change in	Standard employer contribution rate (percentage of pensionable pay)		
	25%-40%	**40-50%**	**50-60%**
Reduced	ENWESPS UKPNPS	NPESPS	
Increased		NGESPS WPDESPS CNESPS	NGUKPS SPPS MANESPS
Unchanged	SGNPS SEESPS	CGPS UKPNESPS	

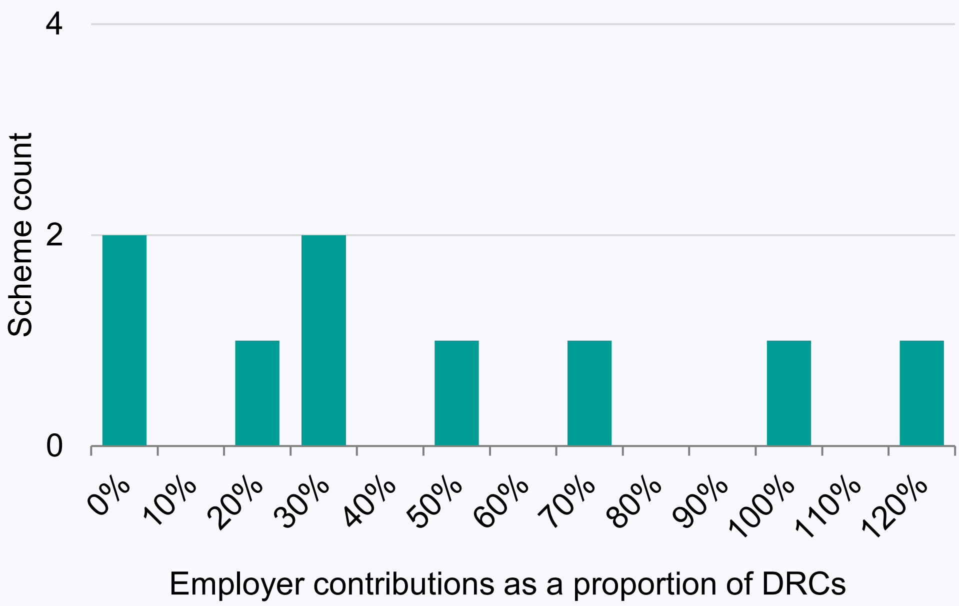
Note: NGNPS and WWUPS are not currently receiving any standard contributions as they have no active members. SHEPS is not currently receiving any contributions due to the employer taking a contribution holiday while it remains in surplus.

3.38 To provide some context to the level of contributions, Graphs 2 and 3 below compare the employer's contributions with the value of the technical provisions, and with the level of deficit reduction contributions.

Graph 2: Employer contributions compared to technical provisions



Graph 3: Employer contributions compared to deficit reduction contributions (DRCs)



3.39 Ofgem may wish to discuss the level of future service benefits with NWOs to seek a more cost-effective outcome for consumers. However, there may be restrictions on the changes that could be made to future benefits, for example due to protected persons legislation.

Benefits

3.40 All of the schemes are closed to new entrants, although most remain open to accrual of benefits to existing members. NGNPS and WWUPS are now closed to future accrual.

3.41 None of the schemes reported amending future benefit accrual since the previous report. While a reduction in future benefits could benefit consumers, schemes may be limited in their ability to make these changes given the protections some members have on their benefits, for example by protected persons legislation. Furthermore, reducing benefit accrual may lead to challenges in industrial relations. Pension benefits are part of a wider reward package and there are many considerations to take into account before reforming such benefits.

3.42 Some NWOs have made other changes to manage liabilities, such as pension increase exchanges, flexible retirement options and transfer exercises. These are summarised in the tables in Appendices C and D. Generally we view these as useful initiatives as they are indicative of employers looking to manage costs and risks, whilst offering members additional flexibility.

3.43 Some NWOs commented on their discretionary benefits practices, in particular the discretion to grant a discretionary increase in excess of the entitlement set out in the scheme rules, to reflect the current high inflationary environment. Several schemes noted that the decision on whether to grant discretionary improvements to benefits lay with the NWO rather than with Trustees and some proposals to apply discretionary increases to benefits in 2022 had been rejected. Again, the tables in Appendices C and D summarise this.

Draft funding regulations and long-term funding objective

3.44 The Department for Work and Pensions (DWP) consulted on draft regulations setting out details of a new requirement for schemes to submit a statement of strategy setting out the scheme's funding and investment strategy to TPR. The key principle of the draft regulations is that scheme should have low dependency on the sponsor by the time they are significantly mature.

3.45 TPR also consulted on funding of defined benefit pensions schemes via its draft revised defined benefit funding code of practice. The draft code of practice sets out guidance on how schemes can comply with the proposed scheme funding requirements.

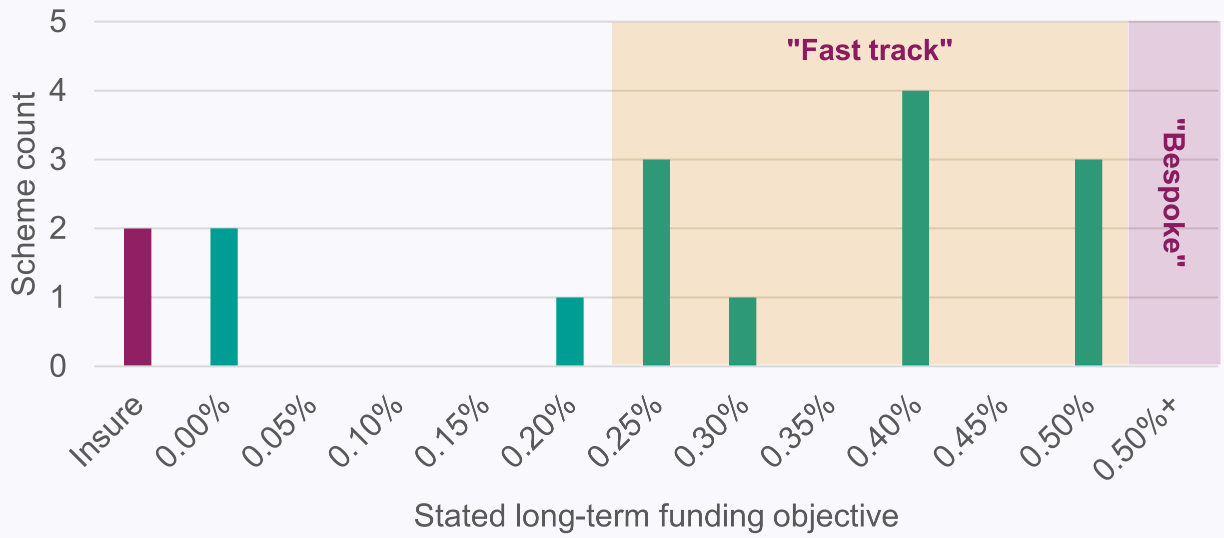
3.46 A focus of TPR's proposed code of practice is on the reduction of risk and long-term strategies of pension schemes. In particular, the consultation proposes a twin track approach to scheme valuations, with "fast track" compliance for schemes adopting a long-term funding basis of no more than gilts+0.5% (plus other detailed provisions) and a "bespoke" approach which will provide more flexibility for schemes that choose not to follow the fast track approach. The bespoke approach is expected to require evidence of suitability and how any additional risk has been managed.

3.47 The consultations are now closed but DWP's and TPR's responses to the consultations have not yet been published. The regulations and code have not yet been put into law.

3.48 Protected persons legislation provides additional constraints on some NWOs.

3.49 As was the case at the 2020 review, all schemes have adopted a long-term funding objective, summarised for each scheme in the Consumer Interest table in Appendix C. Our understanding is that all schemes are planning to adopt a long-term funding objective aligned with a fast track approach in the draft code (between 0.25% a year and 0.50% a year in excess of gilts), as can be seen from Graph 4 below. Graph 4 illustrates the schemes' explicitly stated long-term funding objectives where available, else shows the post-retirement or long-term rate from the most recent Technical Provisions. Three schemes have adopted even more prudent funding targets, with two schemes actively engaged in insuring their liabilities with a third-party insurer.

Graph 4: Count of scheme long-term discount rates (outperformance relative to gilts)



3.50 These NWO schemes might be able to tolerate more investment risk given the strength of the sponsor covenant. If instead schemes were to adopt a bespoke approach, this could reduce expected costs to the consumer, although higher expected returns are likely to be at the expense of greater funding level volatility. However, we recognise that any requirement to have low dependency on the sponsor by the time the scheme is significantly mature may limit the ability of NWOs to negotiate a higher risk long-term strategy.

3.51 Ofgem may wish to set out guidance on its preferred long-term risk position which appropriately reflects the consumer interest, with regard to the implications of protected persons legislation.

Discount rate

3.52 A discount rate is used to express the current value of a stream of future cashflows and is generally set with reference to a scheme's expected return on its assets. Discount rates can be structured in a number of ways including:

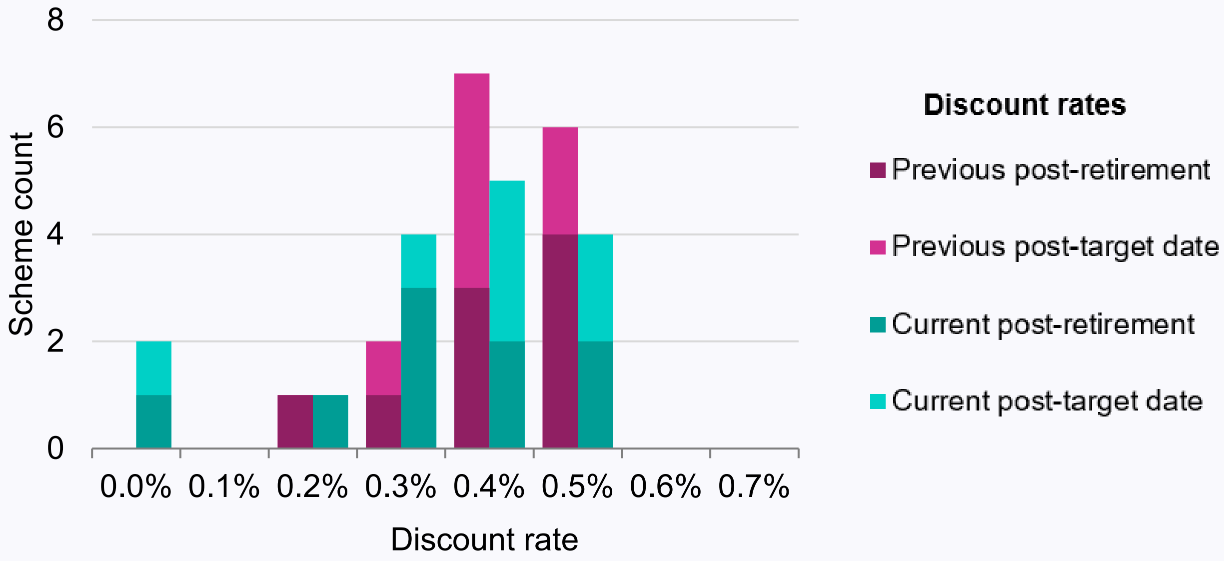
- applying a different rate before and after retirement (reflecting the closer time to payment of pensioner benefits and therefore the need for lower risk investments) or
- applying a different rate before and after a particular date (usually reflecting the date of future de-risking planned in the long-term funding objective)

3.53 All schemes apply one of these approaches, with 9 schemes setting their discount rate with reference to retirement and 7 schemes setting their discount rate with reference to a time horizon. The approaches are unchanged since the previous review.

Long-term discount rates

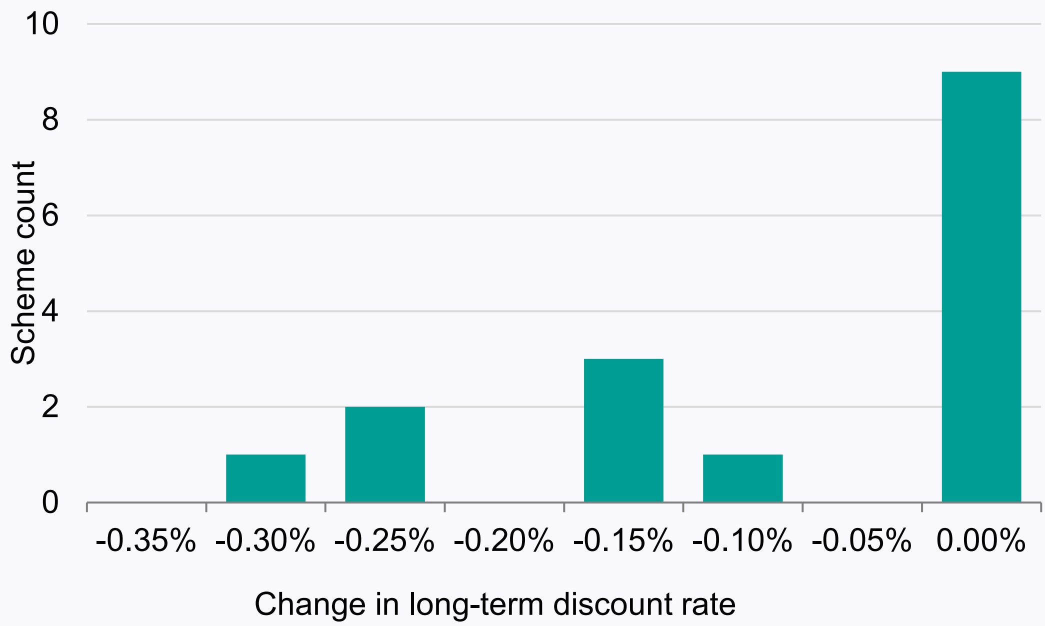
3.54 The long-term discount rates – those that apply after retirement or after a target date – are summarised in Graph 5 below, which shows the number of schemes with each discount rate. This shows that all schemes have adopted post-retirement or long-term discount rates that are more prudent than the fast track approach described in TPR's draft funding code.

Graph 5: Count of schemes with specific long-term discount rates relative to gilts



3.55 Graph 5 indicates that post-retirement discount rates have on average decreased across schemes. This is illustrated more clearly in Graph 6, which shows that half of the schemes have maintained the same long-term discount rates, with the other half reducing the rates by up to -0.3% p.a.

Graph 6: Count of schemes with specific change to their long-term discount rates relative to gilts



Short-term discount rates

3.56 There was also a general trend to reducing short-term discount rates, with ten schemes making a reduction.

- NPESPS decreased the pre-retirement discount rate significantly by -1.6% p.a. so that the scheme now has the same discount both pre- and post-retirement. This scheme now has the lowest pre-retirement discount rate. UKPNESPS also had a significant reduction in pre-retirement discount rate of -0.8% p.a.
- CNESPS and WPDESPS changed from a term-dependent discount rate, with different rates for deferred and active members, to a single rate. The pre-retirement discount rate increased for active members and decreased for non-active members.
- WWUPS retained the same discount rate in the shortest term but added a lower medium-term discount rate
- The remaining five schemes reduced their short-term discount rate by a modest amount (up to 0.5% p.a.).

3.57 Two schemes increased their short-term discount rate by a small margin (up to 0.4% p.a.) and 3 schemes retained the same short-term discount rate.

3.58 The discount rates adopted appear reasonable given the investment strategies in place and wider UK practice.

Investment strategy

Return-seeking assets

3.59 Schemes have a wide range of investment strategies, with the benchmark proportion of return-seeking (or growth) assets held, as disclosed in the questionnaire responses, ranging from 8% to 83%.

3.60 Most schemes reduced the benchmark proportion of return-seeking assets held:

- SEESPS, NGNPS and SHEPS reduced the proportion of return-seeking assets by 20% to 29%.
- CNESPS, WPDESPS and NGESPS reduced the proportion of return-seeking assets by 12% to 17%.
- Nine schemes reduced the proportion by less than 10%.

3.61 MANESPS increased the proportion by 5%.

3.62 A reduction in the proportion of return-seeking assets is a common trend for many UK private sector defined benefit pension schemes as their liability profiles mature. Given all the NWOs' schemes are closed to new entrants, their liability profiles will mature over time and a move from return-seeking assets to lower risk matching assets would be expected. However, a lower risk investment strategy is also expected to yield lower returns in the long term and hence may increase the contributions required.

Inflation and interest rate hedging

3.63 Inflation and interest rate risk emerge from the mismatching of the asset holder's portfolio with their liabilities. An investor's return is not compensated for carrying these risks (although the investor may benefit as well as suffer as a result of any mismatching risk). There has been an increased trend for pension schemes to seek to eliminate interest rate and inflation risk through the adoption of a more matched portfolio.

3.64 Since the previous review, the NWOs' schemes also continue to increase the hedging within their investment portfolios against movements in the liabilities due to changes in the inflation and interest rates. Only SHEPS and UKPNPS maintained one or both of the hedging levels. As commented above, many schemes across the pensions industry were unable to maintain their hedging levels in the 'LDI event' in 2022; some NWOs may have similarly reduced their hedging levels as a result.

3.65 Based on the submissions received (and noting that there may be some differences in the basis that hedging is assessed), all schemes are at least 50% hedged against changes in the level of inflation and 60% hedged against changes in the interest rates.

Buy in

3.66 A buy-in is an insurance policy, whereby an insurance company provides payments to the scheme to pay benefits to members as they fall due. The insurance company bears the risk of changes in the cost of providing benefits (for example because members live longer than expected). However, the buy-in policy is an asset of the scheme, and the scheme retains the risk that the insurance company defaults, albeit such an event is viewed as unlikely.

3.67 NGNPS is now fully bought-in so that all members are covered by insurance policies. SHEPS, NGESPS, NGUKPS and ENWESPS have buy-in policies for some of their members.

3.68 ENWESPS have completed a partial buy-in in respect of its pensioner members since the last valuation.

4. Consumer interest

All companies have been able to describe some 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

We note that some companies have cited more examples than others, although it is recognised that scheme circumstances vary and views on how the consumer is best served can also differ.

Given the scope of this review and the information provided, it is not possible to draw any firm conclusions, and we are not in a position to identify any actions (or lack thereof) which could indicate that companies have not fully acted in consumers' best interests. It is possible that additional actions could have been explored further by some companies since the last reasonableness review. However, we are generally satisfied that NWOs have demonstrated the behaviours we would expect in terms of acting in consumers' interests.

An overview of the actions taken is given in this section, with a more detailed description of the actions cited by each NWO given in Appendix D. The actions of each NWO are summarised in the table in Appendix C. Viable ways to represent the consumer interest will depend on individual scheme circumstances and will vary between schemes.

Approach

4.1 We have considered the main comments provided in NWOs' questionnaire responses, which describe how the NWOs believe they have interpreted the interest of consumers when engaging with the governance of its pension scheme (including setting investment and risk strategies). In this context, examples of actions that may demonstrate that the NWO has actively considered and represented consumer interests may relate to the following (note that this is not an exhaustive list):

- **Governance** – we would expect NWOs to be keen to ensure that their pension schemes have robust governance processes in place and that their running expenses represent good value for money. Ofgem indicated that schemes could explain to Trustees the risks of stranded surpluses and need to consider consumer interests.

- **Long-term objective** – we would expect NWOs to represent consumer interests when discussing the long-term funding objective with Trustees, noting the potential requirements set out under the new draft DB funding code of practice.

- **Investment strategy** – we expect that NWOs would be keen to ensure that the investment strategy reflects an appropriate balance between risk and reward, having considered the perceived risk appetite of its consumers and the prevailing regulation around funding (for example the change noted in the long-term funding objective subsection in Section 3)

- **Valuation outcomes** – evidence that the NWO has represented consumer interests during discussions with the Trustees on triennial valuation outcomes (e.g. relating to assumptions, deficit recovery plans).

- **Managing liabilities** – we would expect NWOs to be managing benefits as efficiently as possible and ensuring that consumers do not meet the cost of any unnecessary benefit provisions (e.g. discretionary pension increases, enhanced early retirement or redundancy terms) and that any potential benefit cost savings are passed on to the consumer. We have summarised the actions companies have stated are in consumer interests but have not considered the legal risk or impact on members. The ability to amend future benefits may be restricted by protected persons legislation.

- **Consideration of stranded surplus** - this is where a scheme is overfunded, but the surplus cannot effectively be used to the benefit of consumers. As schemes are now approaching full funding this is becoming more of a consideration when setting investment and funding strategies. We suggest Ofgem consider policy in this area and establish if the possibility of a stranded surplus is problematic for any of the schemes.

- **Consumer research** – by conducting consumer research schemes will be able to better understand consumers' interests, such as risk appetite, and reflect those interests in their decision making and negotiations with schemes. It is recognised that views will be subjective and reflect how the research was conducted. Further, lay views will need to be interpretated in context and with the support of professional advisers.

- **PPF levy** – the Pensions Protection Fund is the central discontinuance fund for UK defined benefit pension schemes, funded through charging a levy on pension schemes each year similar to an insurance premium. The levy comprises two calculations – the scheme-based levy, based on the size of the scheme, and the risk-based levy, which considers the employer's insolvency risk, the scheme's underfunding risk and the scheme's investment risk. It would be expected that schemes endeavour to take steps to mitigate the size of the risk-based levy through actuarial certification of deficit repair contributions where it is cost effective to do so. The PPF are due to consult on changes to the calculation method of the risk-based levy for 2024/25[1], and NWOs should be aware of any changes to the calculation methodology as a part of their monitoring.

4.2 We recognise that there may be different views on what outcome would best represent consumers in some areas (e.g. the level of risk in the investment strategy). However we understand that Ofgem are particularly interested in understanding the process followed by NWOs in considering the consumer interest.

[1] PPF levy consultation 2024/25

Findings

4.3 All companies have been able to describe some examples of actions which they consider to be evidence of them acting in the consumer interest.

4.4 We note that some companies have cited more examples than others. It is possible that additional actions could have been explored further by some companies since the last reasonableness review. Conversely, actions will need to be prioritised and represent value for money. Given the scope of this review and the information provided, we are not in a position to identify any actions (or lack thereof) which could indicate that companies have not fully acted in consumers' best interests. However, we are generally satisfied that NWOs have demonstrated the behaviours we would expect in terms of acting in consumers' interests. Viable ways to represent the consumer interest will depend on individual scheme circumstances and will vary between schemes.

4.5 Please note we have summarised the evidence provided by the companies. We have not independently verified the accuracy or completeness of the information provided.

Governance

4.6 All NWOs state that they have good governance arrangements, including that they work collaboratively with Trustees, and have actively represented consumers in discussions with Trustees.

4.7 Some NWOs have given further examples, such as:

- collaborating on the appointment of new chairs of the trustee board with professional and industry experience;
- providing training to Trustees on consumer interests or stranded surplus;
- requesting that their advisers carry out analysis on, or explicitly consider, consumer interests.

Long-term objective

4.8 All NWOs provided some information of Trustees' long-term objectives, which are summarised in the table in Appendix C. An overview of long-term objectives is provided in Section 3.

Investment strategy

4.9 Several NWOs state that they have 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 diversification;

- reducing (management and adviser) costs.

Buy-ins (and longevity hedges)

4.10 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. We have not commented on the appropriateness of any buy-ins or longevity hedges; ultimately an insurer will place a cost on a cost of carrying a scheme on a prudent, low-risk basis, and therefore the NWO and customers will be required to meet this high cost. There may be occasions where this is in the best interests of future generations of customers.

4.11 NGNPS have secured insurance contracts for their full membership, thus fully removing risk in the scheme. Many other NWOs have been considering their long-term objective (see above), and are considering the appropriateness of purchasing annuities for the full scheme (or buying out the scheme, by transferring the liabilities to an insurer). The NWOs may benefit from Ofgem guidance on appropriate long-term objectives, balancing the level of risk (variability) against the expected cost.

Valuation outcomes

4.12 All NWOs gave examples of negotiating with Trustees on valuation outcomes in the consumer interest, such as negotiating modified contribution rates below the cost of accrual, or negotiating on the length of the recovery plan or size of the deficit.

4.13 Recovery plan outcomes are discussed in Section 3 and are summarised in Appendices B and D. Generally, NWOs aimed to retain the length of the recovery period and reduce contributions (compared to Trustee proposals).

Contingent assets

4.14 Some NWOs offer contingent assets, such as security and guarantees or asset-backed contributions. This has strengthened their negotiating position to enable less prudent assumptions or longer recovery plans. Given the trend of increased funding positions and the emergence of surpluses, this is of less focus at the 2023 review than at previous reviews.

Managing liabilities

4.15 Most schemes have carried out liability management exercises since the last review. These have included:

- Pension increase exchange (PIE) exercises
- Transfer options
- Early retirement, flexible retirement and voluntary redundancy
- Pension increase engagement

4.16 Some of these were existing options that have helped to improve the funding level of the scheme rather than new company-led exercises. Many schemes have considered PIE exercises alongside a conversion exercise to satisfy the requirement to equalise for Guaranteed Minimum Pensions.

4.17 Many NWOs have commented on their engagement with Trustee boards on constraining the pension increases awarded in the high-inflation environment that has proliferated across 2022 and 2023. Some NWO's, for instance SPPS, NGESPS, WPDESPS and CNESPS were able to use their powers under the Trust Deed and Rules to award pension increases below the uncapped inflationary reference index. The ability and power to restrict pension increases will vary across schemes, and not all NWO's will have had an opportunity to do this. A range of increases were applied in practice and Ofgem may wish to seek further details relating to the process to confirm it is content with the level of increases applied and the associated cost implications for consumers.

Stranded surplus

4.18 All companies have mentioned how it is in the consumer interest to avoid 'stranded surplus' and have given examples of how this has been managed. These include:

- contribution triggers
- valuation outcomes (including negotiation over the length of recovery plans)
- intra-valuation outcomes (e.g. deferring previously agreed DRCs where a surplus has since emerged)
- liability management exercises

4.19 Examples that are detailed elsewhere in the responses have not been repeated in the table in Appendix C as examples of managing stranded surplus.

De-risking

4.20 Some companies have cited de-risking as a strategy to avoid a stranded surplus, as it reduces the likelihood of any surplus. This may not always be in the consumer interest as it may not prevent too much money being paid into the scheme and is expected to reduce the investment income earned from the schemes' assets, potentially increasing cost to consumers.

Expense reserves

4.21 Many NWOs have reported that their schemes have reached a surplus, or near full-funding at their last valuations. Several of the NWOs have outlined that an expense reserve has been established from which to meet the administration and adviser fees, that would otherwise be paid directly from the NWO (and hence their customer). In other cases, the introduction of an expense reserve has been rejected on grounds that this may lead to reduced oversight and control on discretionary spend. GAD consider the introduction of an expense reserve to be a reasonable approach and application of surplus within the scheme, provided there are no concerns about efficient management of expenses and the capacity of the budgeting process to deliver value for money.

Consumer research

4.22 Most companies in recent years have carried out some form of consumer research, such as surveys, focus groups, workshops or consumer feedback, and used the research to inform valuation approaches. Some NWOs have cited analysis performed by other industry participants that they have used to form their own views on consumer interests and priorities. However, care is needed with this approach to ensure that any differences between NWO customer base and scheme specifics are taken into account. It should be recognised that consumer will typically provide lay views and professional advice will be appropriate to support interpretations.

4.23 We note that only a few companies have commissioned new consumer research since the last reasonableness review. However, we would not expect companies to commission consumer research every 3 years in all circumstances.

PPF levy

4.24 We have not identified any particular concerns relating to PPF levies. A number of schemes report having no risk-based levy, reflective of their funding position. The remaining schemes have confirmed that they monitor the levy and perform actions to reduce the levy, for example by the sponsor obtaining and submitting a public credit rating, optimising the timing of submissions or providing certifications of their deficit repair payments.

4.25 Since the last review, the PPF levy rates have reduced, as the PPF has responded to improved funding. Therefore the levies charged to the NWOs are at a generally lower level.

4.26 These actions are summarised in the table in Appendix C.

5. Limitations and compliance

5.1 The purpose of this report is to assist Ofgem in its consideration of price control allowances. This report does not represent advice on the appropriate funding of NWOs' pension schemes.

5.2 For this review we have assumed Ofgem were content with the approach adopted by the NWOs' defined benefit pension schemes at the latest valuations and have therefore only considered how the relevant methods and assumptions have changed since the last valuation.

5.3 The consumer interests summary table is based on our interpretation of the statements provided. Other interpretations may be viable. A blank entry does not necessarily indicate the action has not been undertaken or that it would have been appropriate to do so.

5.4 We have not reviewed any annual funding updates or Pension Deficit Allocation Methodology (PDAM) reports.

Information used

5.5 In preparing this report, GAD has relied on the data and other information provided by Ofgem. In particular, GAD has relied on the general completeness and accuracy of the information supplied without independent verification. In limited instances we have adjusted the data provided in the questionnaires to more accurately reflect the information provided in valuation reports. Where there was an inconsistency in figures that was not resolved, figures provided in the questionnaire were adopted.

Distribution and publication of this report

5.6 This report has been prepared for the use of Ofgem. I am aware that Ofgem may publish this report in full alongside their final decision of the 2023 reasonableness review.

5.7 Advice provided by GAD to Ofgem is intended solely for the use of Ofgem. GAD does not accept any responsibility to any third party who may read this report, or extracts from it, for any action taken or for any failure to act, either in whole or in part, on the basis of this report.

Compliance

5.8 This work has been carried out in accordance with the applicable Technical Actuarial Standard: TAS 100 issued by the Financial Reporting Council (FRC). The FRC sets technical standards for actuarial work in the UK.

Appendix A: Pension schemes and abbreviations

	Defined benefit pension scheme	Abbreviation used	Most recent formal valuation		
			Date	Technical Provisions (£m)	Surplus / (Deficit) (£m)
Gas	Northern Gas Networks Pension Scheme	NGNPS	March 2022	525	(44)
	Scotia Gas Networks Pension Scheme	SGNPS	March 2021	1,258	29
	National Grid UK Pension Scheme	NGUKPS	March 2022	5,726	27
	Cadent Gas Pension Scheme	CGPS	March 2022	6,441	101
	Wales & West Utilities Pension Scheme	WWUPS	March 2022	607	(49)
Electricity	Scottish Hydro-Electric Pension Scheme	SHEPS	March 2021	1,782	268
	Scottish Power Pension Scheme	SPPS	March 2021	3,864	(212)
	UK Power Networks Pension Scheme	UKPNPS	March 2022	657	(133)
	Northern Powergrid Group of the ESPS	NPESPS	March 2022	1,647	3
	ESPS National Grid Electricity Group	NGESPS	March 2022	3,423	(60)
	ESPS UK Power Networks Group	UKPNESPS	March 2022	4,131	(22)
	ESPS Manweb Group	MANESPS	March 2021	1,360	(291)
	ESPS ENW Group	ENWESPS	March 2022	1,398	(19)
	ESPS Southern Electric Group	SEESPS	March 2022	2,475	(80)
	ESPS WPD Group	WPDESPS	March 2022*	N/A*	(67)
	ESPS Central Networks Group	CNESPS	March 2022*	N/A*	(39)

*These schemes had not finalised their valuations at the time of providing information. The questionnaire provided figures from draft valuation results based on initial proposals. No draft report was provided and therefore we were unable to populate the (draft) value of technical provisions.

Appendix B: Summary of funding approaches

The following table summarises the main differences between the two most recent formal actuarial valuations.

	Scheme	Year of latest valuation	Change in funding level (assets / liabilities)	Change in recovery end date (years)	Change in recovery period annual amount[2]	Change in employer contributions pa[3]	Change in discount rate relative to gilts (pre-/post retirement)[4]		Change in return seeking asset allocation	Change in hedging		Buy in
							Pre	Post		Inflation	Interest rate	
Gas	NGNPS	2022	-7%	+8.1	Higher	N/A	0.0%	0.0%	-26%	+25%	+25%	Yes
Gas	SGNPS	2021	+12%	N/A	N/A	0%	+0.4%	0.0%	-9%	+1%	+9%	No
Gas	NGUKPS	2022	+1%	N/A	N/A	+5.4% to +8.4%	-0.0%*	0.0%	-8%	+16%	+16%	Yes
Gas	CGPS	2022	+3%	N/A	N/A	0%	Change*	-0.15%	-1%	+20%	+17%	No
Gas	WWUPS	2022	+3%	0.0	Similar	N/A	0.0%*	-0.3%	-3%	+5%	+5%	No
Electricity	SHEPS	2021	+7%	N/A	N/A	Contribution holiday	-0.5%	-0.25%	-20%	0%	0%	Yes
Electricity	SPPS	2021	+6%	0.0	Lower	+2.4%	-0.25%*	0.0%	-9%	+19%	+29%	No
Electricity	UKPNPS	2022	+0%	+1.9	Similar	-1%	0.0%*	0.0%	-2%	0%	+30%	No
Electricity	NPESPS	2022	+7%	N/A	N/A	-3%	-1.6%	-0.1%	-6%	+24%	+24%	No
Electricity	NGESPS	2022	+5%	-0.5	Similar	+1%	0.0%	-0.25%	-12%	+17%	+17%	Yes
Electricity	UKPNESPS	2022	+9%	-2.0	Similar	+0%	-0.8%*	0.0%	-9%	+18%	+17%	No
Electricity	MANESPS	2021	+3%	0.0	Similar	+5%	-0.25%*	0.00%	+5%	+26%	+25%	No
Electricity	ENWESPS	2022	+4%	0.0	Similar	0%	0.1%	0.0%	-6%	+12%	+3%	Yes
Electricity	SEESPS	2022	+8%	0.0	Lower	0%	-0.4%	-0.1%	-29%	+17%	+21%	No
Electricity	WPDESPS	2022	+8%	-1.9	Similar	+6.6%	Change	0.0%	-14%	+11%	+20%	No
Electricity	CNESPS	2022	+8%	-1.0	Lower	+7%	Change	-0.15%	-16%	+14%	+23%	No

[2] Schemes marked with N/A had a funding surplus and therefore had no DRCs
[3] Schemes marked N/A have no active members and therefore no standard employer contributions; Schemes may allow for expenses in different ways in their contributions and some schemes may have changed the way of allowing for such expenses since the previous valuation. These factors may impact on comparisons between scheme contributions.
[4] Those marked with a * have a discount rate structure before/after a long-term funding target date rather than before/after retirement.

Appendix C: Summary of representation of consumer interests

We have provided a simplified summary of the reported recent actions taken by NWOs to reflect consumer interests in the table below. This table is based on information reflected in companies' consumer interest questionnaire response, as provided by Ofgem.

All companies state that they have actively represented consumers in discussion/committee meetings involving the trustees. This is in part expected due to statutory requirements.

The summary table is based on our interpretation of the statements provided, other interpretations may be viable. A blank entry does not necessarily indicate the action has not been undertaken or that it would have been appropriate to do so, as:

- the relevant information may have been omitted from the statement
- viable ways to represent the consumer interest will depend on individual scheme circumstances and will vary between scheme, so not all the actions may be relevant to all schemes

We note that some companies have cited more examples than others. It is possible that additional actions could have been explored further by some companies since the last reasonableness review. However given the scope of this review and the information provided, we are not in a position to identify any actions (or lack thereof) which could indicate that companies have not fully acted in consumers' best interests.

	Scheme	Investment strategy reviewed	Valuation concessions: Assumptions negotiations	Valuation concessions: Recovery plan	Valuation concessions: Contribution rate (accrual)	Liability management	Buy-in or longevity hedging	Expense reserve	PPF levy	Consumer research since last review
Gas	**NGNPS**	Yes	No	Yes	n/a	PIE and IFA support	Full buy-in	No	No risk-based levy	No
Gas	**SGNPS**	Yes	Yes	n/a	Yes	None	None	No	Monitored	Yes (3-yearly)
Gas	**NGUKPS**	Yes	No	n/a	No	IFA support	Partial buy-in	Yes (after 2026)	No risk-based levy	No
Gas	**CGPS**	Yes	Yes	n/a	Yes	IFA support	None	Yes	No risk-based levy	Customer engagement (pensions not discussed specifically)
Gas	**WWUPS**	Yes	No	No	n/a	IFA support	None	No	No risk-based levy	No
Electricity	**SHEPS**	Yes	No	n/a	Yes	FRO	Partial buy-in	Met from surplus	No risk-based levy	No extensive engagement
Electricity	**SPPS and MANESPS**	Yes	Yes	Yes	Yes	FRO, PIE, Pension increase cap	Longevity swaps	No	No risk-based levy	No
Electricity	**UKPNESPS**	Yes	Yes	No	Yes	PIE, Pension increase cap	None	No	Certify DRCs, time S179 submission	No
Electricity	**UKPNPS**	Yes	Yes	Yes	No	None	None	No	Certify DRCs, time S179 submission	No
Electricity	**NPESPS**	Yes	No	n/a	No	Pension increase cap	None	Yes	No risk-based levy	No
Electricity	**NGESPS**	Yes	Yes (revised contributions)	n/a	Yes	IFA support, Pension increase cap	Longevity hedge	Yes	No risk-based levy	No
Electricity	**ENWESPS**	Yes	No	n/a	None	PIE, Pension increase cap	Partial buy-in	Yes	No risk-based levy	No
Electricity	**SEESPS**	Yes	Yes	Yes	Yes	FRO	None	No	No risk-based levy	No extensive engagement
Electricity	**WPDESPS and CNESPS**	No	TBC / revised contribution schedule	TBC	TBC	Pension increase cap	None	Yes	No risk-based levy	No

Appendix D: Representation of consumer interests

	Acting in the consumer interest – examples presented by companies as evidence
NGNPS	**Governance:** The company reports collaboration with the scheme through a joint working group and meetings between seniors. It believes this relationship allows them to manage key risks and effectively represent consumer interests in its discussions. As an example, it cites being consulted on actuarial factors used to calculate member options such as early retirement. It also works to improve Trustee understanding of the regulatory framework and its impact on consumers. Its advisors consider consumer interests, and in particular it has commissioned advice and analysis to confirm that its actions have been in the interests of consumers. **Long-term objective and investment strategy:** The company and Trustee agreed to a pensioner buy-in in 2020. The company and Trustee have agreed that the scheme should move to a fully insured position and at the date of this report all of the scheme's benefits have been insured although the Scheme has not yet been wound-up. **Valuation outcomes:** The company requires evidence from Trustee to justify updates to assumptions, which is reviewed by the company's advisors. The company negotiated that the final payment from the recovery plan agreed at the 2019 valuation should be deferred, reflecting the favourable position of the scheme. **Managing liabilities:** The company has reduced the risk profile of the scheme liabilities via a pension increase exchange option exercise and continuing its shareholder-funded early retirement programme. The company has proceeded with an insurance buy-in of benefits to protect consumers and reduce the risk of a stranded surplus. **Actions taken to prevent stranded surplus:** The company advises it has negotiated with the insurer that a part of the buy-in premium could be deferred, with the intention that this could be met with the future redemption of the illiquid part of the investment portfolio. This prevents excess or unnecessary contributions being paid into the Scheme in the near-term. **Consumer research:** The company believe a lower risk strategy is in consumer interests to avoid volatility and risk of stranded surplus.
SGNPS	**Governance**: The company reports collaboration with the scheme through a joint working group and meetings between seniors. It describes the relationship as professional, objective and collaborative. Trustees also attend company board sub-committee meetings as required. The company reports working together with trustees to develop and review an overall pension scheme strategy (including the management of risks). Both the trustees and company monitor the situation jointly and separately with jointly agreed interventions. The company has independent advisors. A new professional trustee was appointed at Chair of Trustees. **Long-term objective:** Consulting with consumers on a revised long-term objective. The long-term objective is to hold a portfolio of assets with contractual cashflow to meet the liability payments. Credit is expected to make up a significant part of the portfolio. The insurance market (annuities / longevity hedges) will also be monitored with a view to transacting if the terms are right

	Investment strategy: Since 2020 the company has moved c. 10% of its assets from growth to income generating and protection type assets. The company states that its investment strategy has resulted in a reduction in pension costs for consumers and crystalises the gains experienced in recent years. **Valuation outcome**s: The company reports resisting or not agreeing actions which would increase costs for consumers, including accelerated asset de-risking, benefit improvements (e.g. higher commutation factors), and excessive margins for prudence in valuation assumptions. **Managing liabilities:** Flexible retirement options have reduced the number of active members. The company is monitoring demand for further exercises in future. Following the increase in bonds yields, the company initiated a review of the option terms to avoid excessive cash commutation payments out of the scheme. **Actions taken to prevent stranded surplus:** The company agreed with the trustees that the costs in respect of future accrual would be met by a combination of investment returns and cash contributions, with the intention to avoid unnecessary margins for prudence and therefore minimising the chance of trapped surplus. **Consumer research:** The company proactively commissioned a consumer consultation from an independent advisor on the revised long-term objective for its pensions strategy.
NGUKPS (Section B)	**Governance:** The company state that it has a strong collaborative working relationship with the trustees. The company regularly attends Trustee meetings and Funding & Investment Committee meetings to input on the consumer perspective in all investment and de-risking decisions. It also provides training to Trustees to help them consider consumer impacts. The Trustees monitor risks and update the Funding and Investment Committee (which includes a company representative) at least quarterly. The company states that the impacts of investment decisions and valuation outcomes are continually analysed for their effect on consumers. The company uses its own valuation methods to evaluate Trustee investment and valuation proposals and to monitor consumer risk exposures. This allows them to strongly represent stakeholder and consumer interest to the Trustees. **Long-term objective:** To get to a position of self-sufficiency in the medium term, with a targeted date 2030. **Investment strategy:** The risk in the investment strategy has been reduced as the funding level has increased, locking in previous positive investment performance for consumers. Additional de-risking triggers are in place that provide further protection to consumers. Since the 2016 valuation there has been an increase in hedging of interest and inflation risk, a pensioner buy-in and a reduction in equity and hedge fund exposure. **Valuation outcomes:** The company has provided additional security and guarantees to minimise prudence in the technical provisions. This, combined with analysis of consumer impacts, has enabled the company to successfully negotiate a recovery plan which ends 3 years earlier, which it feels protects future cohorts of consumers paying for historic deficits, ongoing contributions maintained at the current level, and scheme funding for administration costs and the PPF levy from 2026. **Managing liabilities:** The company reports it has carried out a pensioner buy-in which removed mortality risk without any increase to scheme technical provisions deficit at the time, it introduced a member transfer tool in 2019 and gained Trustee agreement to consider future option exercises to reduce risk. **Consumer research:** The company has previously reported that it unsuccessfully worked with other members of the Energy Networks Association to achieve a consensus view of how to manage consumer interest, but concluded that investment strategies are best

	tailored to scheme characteristics. It also considered other schemes' research and agreed with NPG's research that its consumers prefer certainty and are risk averse.
CGPS	**Governance:** Established January 2020 with a bulk transfer of existing assets and liabilities of Section C of NGUKPS received in September 2020. The company states that it works with the CGPS Trustees to maintain a strong relationship, to represent customer interests and highlight the need to avoid a stranded surplus. It regularly attends Trustee meetings and sub-committee meetings and engages with the Trustee Executive team. The company reports actively engaging with the Trustee to manage risks in the interests of both scheme members and consumers. **Long-term objective:** The Trustees' long-term target is to be fully funded on the basis of gilts + 0.25% discount rate, but the company has not formally agreed this target. Based on scheme actuary projections as at 31 March 2023, the Scheme might be expected to reach full funding on the LTO basis by 31 December 2026 if asset returns are in line with gilts+1% p.a. **Investment strategy:** The CGPS Trustee board and their advisors undertook a review in March 2023, with the focus on the impact of the significant changes in bond yields. Perceived unrewarded risks, such as interest rate and inflation, have been reduced through hedging Restructuring the LDI portfolio freed up capital to invest funds in higher yielding assets without significantly increasing overall portfolio risk. The company view this as in the best interests of the consumer. Overall, the scheme has a low cost cashflow driven investment strategy that seeks to match payments as they become due. **Valuation outcomes:** The company reports it negotiated for discount rate and demographic assumptions that were broadly neutral in overall impact on the calculation of the Technical Provisions. The discount rate at the valuation was set higher than the Trustees long-term target. The company agreed with the Trustee that the scheme expenses would be met from the scheme assets (and therefore the surplus). It was also agreed that a modified contribution rate, below the true cost of accrual, would be paid by the company in recognition of the surplus. **Managing liabilities:** The company is currently consulting with members over a plan to cease the accrual of benefits in the scheme from 31 December 2023. The Company were consulted on the appropriate method to use for GMP equalisation. The company refused to give consent for Method B, and Method C2 will be used instead, reducing the impact by circa £30m. **Actions taken to prevent stranded surplus**: A calculation error in the 2019 valuation was observed, that would have resulted in a restatement of the CGPS liabilities of £45m. As a result of a favourable valuation update as at 31 March 2021, Cadent agreed with the Trustee not to restate the 2019 valuation result, which would have required additional deficit repair contributions as this would have led to an increased surplus at the 2022 valuation. The company state that the valuation outcomes achieved were facilitated by its security arrangements, and that this has reduced the risk of a stranded surplus. **Consumer research:** The company reports that it carried out workshops with consumers and identified a consumer preference for Cadent offering its employees a quality working environment with fair pay and benefits package.
WWUPS	**Governance:** The company cites a strong relationship with the Trustees and takes the view that the interests of consumers are best served by a positive constructive relationship and continual dialogue. It regularly works with Trustees, attending Trustee meetings and exchanging formal correspondence. It negotiates to balance the needs of consumers with those of other stakeholders.

	It also proactively engages with the Trustees in managing risks, taking into account the interests of the customers. **Long-term objective:** The long-term objective is to buy-out the scheme with an insurer in 2031 and deficit contributions and investment strategy have been chosen with this objective in mind. **Investment strategy:** Substantive changes in the investment strategy have been introduced since the 'LDI event' in 2022, the allocation to LDI-type assets has been increased in response to achieving less levered positions. A medium-term objective is to divest from illiquid holdings. **Valuation outcomes:** The company negotiated to retain the current recovery period up 2031, consistent with the recovery plan end date from the 2021. The objective is to buy annuities and wind up the scheme in 2031. **Actions taken to manage liabilities**: The company closed the scheme to future accrual on 31 July 2021, preventing the further build-up of pension benefit and breaking the salary link. The company reports it has reduced risk and improved the funding position by supporting process for members to opt to transfer out at retirement, including by providing access to a preferred IFA. The DC section of the scheme was closed in 2022, with all contributions going to the Master Trust (that is also used for form DB Section members). This is expected to reduce the level of professional fees. **Actions taken to prevent stranded surplus:** The company reports that it has also obtained guidance on implementing an asset backed funding arrangement. Such an arrangement was previously rejected by the company, but the position is kept under review. **Consumer research:** The company state it has conducted a comprehensive customer and stakeholder engagement programme to better understand customers' perceptions and reflect their preferences in the 2019 business plan.
SHEPS and SEPS	**Governance:** The company describes its engagement with Trustees as pro-active. and states that it attends quarterly Trustee meetings and has appointed senior finance and investor relations colleagues to act as Trustees. Regulatory finance teams present to the Trustees annually. **Long-term objective:** To be fully funded on a gilts basis by 2033, including all future service post 2033, for SHEPS and to be fully funded on a gilts basis by 2030 for SEPS. **Investment strategy:** The strategy aims to reduce volatility and rely on consumers less and the scheme has put in place de-risking triggers. Both SHEPS and SEPS have increased inflation and interest rate hedging, reduced equity and property investments, and moved to secure income and credit-based strategies. **Valuation outcomes:** The company secured a contribution holiday for SHEPS given their surplus while the gilts funding level of the scheme remains above 100%. For SEPS, the company negotiated with the Trustees to reduce the previous level of deficit repair contributions and also reduce some investment risk. **Managing liabilities:** The company has previously stated that it has either implemented or considered: a transfer support process, annual and lifetime allowance support, flexible retirement options, and a sale of business leading to bulk transfer.

	SHEPS has hedged longevity with a combination of pensioner and dependent longevity swap and buy-ins, which has improved funding. SEPS is considering transferring longevity risk now that funding has reached 90% on a gilts basis. on triggers. **Actions taken to prevent stranded surplus:** The company state that it seeks to minimise the risk of any stranded surplus, by using any assessed surplus at a given valuation date to mitigate cash costs to consumers and the Group, or to facilitate further de-risking (such as insurance transactions or increased hedging). **Consumer research:** The company reports engagement with stakeholder representatives and explicitly acknowledge the consumer within their dialogue with the Trustee.
SPPS and MANWEB	**Governance:** The company states that it works with Trustees, attending quarterly Trustee meetings and engaging when material events take place. **Long-term objective:** The company reports a long-term funding objective to reach full funding on a basis of gilts +0.4% by 2028 for both schemes. **Investment strategy:** The company states it negotiated increased diversification in the investment portfolio and agreed a liability driven investment framework which partially hedges the inflation and interest rate, intending to reduce volatility, which is an important factor for consumers. Stochastic modelling was used to assess potential investment strategies against consumer interests and other practical considerations. A high-level review of the investment strategies was undertaken in 2021. **Valuation outcomes:** The company undertook a detailed review of prudence in the proposed 2021 valuation assumptions. The company successfully negotiated that the stochastic framework for deficit reduction contributions should target 67% chance of reaching the long-term objective by 2028 (previously greater than 67%). A reduced margin for GMP equalisation was successfully negotiated following member analysis. **Managing liabilities:** Flexible retirement and pension increase exchange options are already available at retirement for active members. The longevity swaps mitigate against adverse demographic risk. A weaker CETV basis was successfully negotiated with the Trustee. The company was able to successfully restrict the annual pension increase in March 2022 and March 2023 on the SPPS, capping the increase at 5%. The company was able to partially restrict the increase on MANWEB at April 2023 (despite the ‘best endeavour’ commitment to link increases to RPI), to 11.1% rather than the full 12.6% RPI increase. Legal advice is being sought on whether the ‘best endeavour’ commitment is of a contractual nature or whether the company can legally restrict future increases. **Consumer research:** The company commissioned a consumer survey in 2020 which it reports showed that the key areas of importance from a consumer perspective were the pension cost element of future bills and the year-on-year variability of bills due to pension costs.
UKPNESPS and UKPNPS	**Governance:** The company states that it has an open and collaborative working relationship with the Trustees, with regular company engagement (including senior management) with the Trustees. The Company has previously agreed formal undertakings, including contingent asset security, which support a continuing ‘strong’ covenant assessment. **Long-term objective:** To achieve full-funding on a low-risk basis, incorporating a discount rate of gilts +0.5%, before a very high degree of maturity is reached: on UKPNESPS this is 2026, on UKPNPS this is 2055, with gradual de-risking expected up to this point. **Investment strategy:** there has been material de-risking in UKPNESPS, following recent improvements in the funding level. Between 2021 and 2023, the target return reduced by

	0.9% and the allocation to growth assets reduced from 67% to 25%. A smaller de-risking step was implemented for UKPNPS, noting its relative immaturity. UKPNESPS employs inflation and interest rate hedging based on 100% of asset value. Hedging levels have also increased in UKPNESPS in recent years, with current levels of 90% (interest rate) and 80% (inflation). **Valuation outcomes:** The company reports that it negotiated a UKPNESPS valuation outcome which resulted in deficit reduction contributions ceasing after the 2022 valuation. For UKPNPS, the deficit recovery period was revised so there was no increase in deficit recovery contributions. CPI has been incorporated into the salary increase assumption which is material for UKPNPS due to the membership demographic. Amendments have been made to contingent contribution requirements. **Actions taken to prevent stranded surplus:** The company states it has already given initial consideration to using an escrow arrangement and have raised this as an option with the Trustee for future formal valuations. The company opted not to introduce an expense reserve at this time, reasoning that this would present less control and oversight of discretionary spend. **Managing liabilities**: The company has explored a number of options for managing its liabilities, including a Pension Increase Exchange, enhanced transfer value exercise and incentivised retirement, which have resulted in a range of savings. Related expenses have been claimed under pensions initiatives; Ofgem may wish to further understand the process to establish value for money, noting the limited liability savings associated with the transfer value and incentivised retirement exercises. For UKPNESPS, the Company negotiated a pension increase based on CPIH, rather than full RPI, after initially proposing a 5% cap. Different companies settled on different capped increases; Ofgem may wish to consider the level and specific circumstances relating to each increase and the implications for consumer costs.
NPESPS	**Governance:** The company states that it has a strong and constructive working relationship with the Trustees, which enables them to represent the consumer interest on key decisions. It has an in-house pensions team, supported by external expert advisers, as necessary. **Long-term objective:** The trustees are targeting a low-risk funding strategy, whilst aiming to ensure that no further deficit contributions are paid into the scheme. The 2022 valuation reflected a low-risk funding basis, based on a discount rate assumption of Gilts + 0.3% a year. **Investment strategy:** The investment strategy is under review in light of the more conservative funding approach adopted at the 2022 valuation, The scheme invests around 50% of its assets in return-seeking assets. The company note that there may be scope for substantive de-risking relative to the low-risk funding approach. The scheme's interest and inflation risks are close to 100% hedged, increasing from 75% at the 2019 valuation. **Valuation outcomes:** A significant reduction in the discount rate was agreed at the 2022 valuation, in view of the improved funding position. An expense allowance at the 2022 valuation will also see expenses being met by the scheme assets rather than the company going forward. **Managing liabilities:** The company restricted the size of the pension increase in April 2023 to 6.5%, capped relative to a full RPI increase of 12.6%, and therefore limiting consumer costs. Different companies settled on different capped increases; Ofgem may wish to consider the level and specific circumstances relating to each increase and the implications for consumer costs.

	A PIE exercise was considered in conjunction with a GMP conversion process. However, it was decided not to progress the PIE exercise at this stage, Options for managing the liabilities will be considered as part of the process for setting the long-term objective. **Actions taken to prevent stranded surplus:** A “stranded surplus mechanism” was implemented at the 2019 valuation which led to the suspension of deficit contributions in 2021 and 2022. This reflected an improvement in the scheme’s funding position which triggered the suspension of contributions, mitigating the risk of a stranded surplus.
NGESPS[5]	**Governance:** The company state that it has a strong collaborative working relationship with the trustee board and regularly attends trustee meetings to input on the consumer perspective and ensure that this informs decision making. The trustee view of the employer covenant has improved and was considered “strong” at the 2022 valuation. The company notes that it is actively involved in ongoing monitoring of expense levels and value for money appraisals. **Long-term objective:** This is being reviewed with a key objective of self-sufficiency in the medium term. The company intends to continue exploring de-risking opportunities with the trustee, to the extent de-risking can be supported by the funding position and aligns with the consumer interest. The post-retirement discount rate has been reduced from 0.5% to 0.25% a year above gilts at the 2022 valuation. **Investment strategy**: The scheme has de-risked significantly following improvements in its funding position. The scheme has increased its inflation and interest rate hedging positions, whilst reducing the allocation to return-seeking assets. The scheme has also hedged a proportion (65%) of its longevity risk and has de-risking triggers in place. The company believes that the recent investment strategy changes are in the consumer interest with lower costs and reduced risk of future deficits emerging. The company wishes to continue exploring de-risking options with the trustee in light of improvements in the funding position. **Valuation outcomes:** Further, the 2022 valuation outcome incorporated an expense reserve (administration costs are now borne by the scheme assets), whilst future service costs remained at The company states that it has reduced contribution requirements by negotiating the removal of the deficit repair contribution due to be paid in 2023. broadly similar levels to those at the 2019 valuation. **Managing liabilities:** The company enforced their power to cap pension increases at 5% in 2023 to ensure additional costs of full RPI indexation were not passed on to the consumer. The scheme provides IFA support for members to enable informed decisions on pension options, e.g. the merits of taking a transfer out. Recent scheme experience has led to a notable reduction in liabilities due to transfers out and a corresponding reduction in scheme risk.
ENWESPS	**Governance:** The company states that it has a strong relationship with Trustees. The company has a joint working group with the Trustees and report collaborative working. The company takes independent advice. **Long-term objective:** To be fully funded on a discount rate of gilts +0.5%; the strategy does not preclude pursuing buy-in options, subject to market pricing and compatibility with the consumer interest. **Investment strategy:** since 2019, the Scheme has entered into a pensioner buy-in arrangement (covering around half the liabilities). The Statement of Investment Principles was updated in Q1 2023, to take into account: (i) the pensioner buy-in, (ii) reduced hedging levels in view of the systemic LDI stress in 2022, and (iii) revised asset allocations to target outperformance above the Technical Provisions basis.

[5] Joint response by National Grid Electricity Transmission licensees (Electricity Transmission Operator and Electricity System Operator), which legally separated on 1 April 2019.

	Actions taken to prevent stranded surplus: The company viewed the pensioner buy-in as an action that has reduced the risk of a trapped surplus. The Company and Trustee have explored the option of an escrow account. A decision was taken not proceed due to concerns around tax implications, however the Company notes that an escrow account may be a feasible option to mitigate a trapped surplus risk in future. An expense reserve has been established to fund future administration expenses from the scheme. **Managing liabilities:** The company reports constructive engagement with the Trustee on some strategic issues relating to management of the liabilities. For example, a pension increase exchange exercise was introduced which has led to a reduction in the funding deficit. The Company also exercised its available powers to limit the pension increase payable in April 2023 to 5%, noting that an uncapped increase of 12.6% (as proposed by the Trustee) would expose customers to higher funding costs. **Consumer research:** The most recent research was carried out in 2019. The company advisers have since analysed the results and concluded that customers typically prefer lower risk and are supportive of the pensioner buy-in.
WPDESPS and CNESPS	**Governance**: The company regularly engages with the respective Trustee Boards, and describe the relationships as professional, cordial and based on mutual trust. The general approach taken is to challenge Trustee proposals on the grounds of consumer costs, only accepting changes that are consistent with market peers and practice. **Long-term objective:** The objective held by the company is for a low dependency on the covenant. The long-term objective will be considered as part of the 2022 valuation process and subsequent investment strategy review. The Trustees have respectively determined a funding target appropriate to this basis. **Investment strategy:** The company intend to review the investment strategy in 2023 following the conclusion of the 2022 valuations. There has been a reduction in the proportion of return-seeking assets within the portfolios since the previous reasonableness review, coinciding with an increase in the hedging against interest rate and inflation risk. The reduction in return-seeking asset allocation was implemented in view of an improvement in funding level since the previous valuations. The Company views this change as consistent with the consumer interest as it would reduce the risk of sizeable deficits emerging in future. **Valuation outcomes:** The company states that for CNESPS that it renegotiated the Schedule of Contributions in 2021, which resulted in savings relative to previously agreed pension cost allowances. **Managing liabilities**: The Company reports that it has managed the cost of benefit provision by limiting the increases applying to pension to below the relevant level of Retail Price Inflation (RPI) in 2022. The Company's position led to robust discussions with the Trustees. In that context, the Company sought legal advice to ensure a suitable approach to pension increase determination was followed. The process and level of increases applied varied between the schemes. More generally, different companies settled on different capped increases; Ofgem may wish to consider the level and specific circumstances relating to each increase and the implications for consumer costs.