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Price Control Pension Principles Consultation document

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

Overview: Ofgem regulates the 14 DNOs and the 8 GDNs, who are all regional monopolies and the 4 TOs, also monopolies, to protect the interests of current and future gas and electricity customers. We set the total revenue that allows an efficient network company to finance its business together with commercial incentives to improve their efficiency and quality of service. We do this by setting a price control every five years.

As part of setting total revenues we consider the treatment of pension costs. In 2003 we set out our principles for the treatment of pension costs and have applied these through three price controls - electricity distribution (DPCR4), transmission (TPCR4) and gas distribution (GDPCR). After one full round of price controls and given recent developments in the pension environment, including the sharp rise in defined benefit pension costs, we think it is the right time to review the working of the principles. We would welcome views on whether our current principles remain appropriate or could be improved. We also seek views on whether changes should be implemented at the start of the next electricity distribution price control period in April 2010 or as part of our "RPI-x@20" review of incentive regulation which is due to report in 2010. In this document we set out our initial thoughts on the principles, the issues we propose to address and the process we intend to follow.

We would welcome comments and views on the issues raised by this consultation by Friday 26 September 2008.

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Context

Ofgem's principal objective is to protect the interests of consumers. For the monopoly energy networks, this means regulating the charges customers pay and the quality of service that they receive. The energy networks comprise the 14 DNOs, the 8 GDNs, who are all regional monopolies and the 4 TOs, also monopolies. We regulate the network operators (licensees) by setting a price control every five years. The price control sets the total revenues that each licensee can collect from customers at a level that allows an efficient business to finance their activities. We also regulate the structure of their network charges, i.e. how they recover these revenues from different customer groups (such as business and domestic customers).

As part of setting the total revenue we consider the treatment of pension costs. In 2003 we set out our principles for the future treatment of pension costs. These principally relate to the regulatory treatment and recovery of costs associated with defined benefit pension schemes. We have applied these with minor refinements through three price controls. After one full round of price controls, and recognising the significant changes in the pension environment, including significant increases in the costs of employer contributions for defined benefit schemes, we think it is appropriate to review the working of the principles.

We will consider what changes to the principles or the way we apply them should be implemented from April 2010 which marks the start of the next distribution price control period (DPCR5), and what issues should be considered further through the RPI-x@20 review[1], which will conclude in two years time. As well as considering the incentive on monopoly network licensees to manage the cost of defined benefit schemes, we will take into account the impact that substantial changes to our approach may have on the risk and reward balance of the companies.

In this document we set out our initial thoughts on the working of the principles, the changing pension environment, the new issues we propose to address and the process we intend to follow. All of the views we express in this document are provisional and subject to us considering all of the responses to this document.

We will publish a DPCR5 policy paper in December 2008 and will incorporate the outcome of this consultation and our emerging thinking and conclusions on our pension principles in that document.

[1] "RPI-x@20" Ofgem to review regulatory regime for energy networks (R/8) http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=181&refer=Media/PressRel

Associated Documents

- Developing Network Monopoly Price Controls May 2003 (54/03)http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=41&refer=Networks/Policy
- Distribution Price Control Review 4 – Final Proposals (265/04) http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=51&refer=Networks/ElecDist/PriceCntrls/DPCR4
- DPCR5 - looking ahead an initial consultation letter (119/07) http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=1&refer=Networks/ElecDist/PriceCntrls/DPCR5
- Gas Distribution Price Control Review Final Proposals Consultation Document (285/07) http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=362&refer=Networks/GasDistr/GDPCR7-13
- Transmission Price Control Review: Final Proposals (206/06) http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=191&refer=Networks/Trans/PriceControls/TPCR4/ConsultationDecisionsResponses
- DPCR5 Initial Consultation document (32/08) http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=18&refer=Networks/ElecDist/PriceCntrls/DPCR5
- Ofgem to review regulatory regime for energy networks (R/8) http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=181&refer=Media/PressRel

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Summary

Ofgem regulates the electricity and gas distribution and transmission network operators, who are all monopolies, to protect the interests of current and future customers. We set a price control every five years that determines the total revenues for each licensee. As part of setting the allowed revenues, we assess the efficient level of pension costs for the businesses. In 2003 we set out some principles for the treatment of pension costs, in particular those arising from defined benefit (DB) schemes and have applied these with minor refinements through three price controls - DPCR4, TPCR4 and GDPCR.

The DB schemes were originally the pension schemes of the nationalised gas and electricity industries prior to privatisation. At privatisation employees were given certain protected rights but most of the schemes are now largely closed to new employees. The aggregate DB current funding allowance[2] set for the monopoly networks is £441 million per year. However, the regulatory treatment provides that we allow the companies to recover their actual pension costs, provided that they are economic and efficiently incurred, at the subsequent price control. For DNOs actual deficit repair payments and normal contributions are currently exceeding the annual allowances by around 25% and we are advised by DNOs to expect further cost increases. We expect to see a similar trend of pension costs exceeding the price control allowances that have been set for the transmission companies.

There have been significant developments in the UK pension environment since 2003, including the Pensions Act 2004, which led to the introduction of the Pensions Regulator and the Pension Protection Fund (PPF). There have been changes in mortality, investment yield assumptions, and the introduction of scheme specific funding. Since we set the principles we have continued to observe a sharp rise in employer contribution rates and deficit repair payments, for which gas and electricity customers are paying higher network charges.

Given these changes in the UK pension environment, we think it appropriate to review the working of the 2003 principles. We are consulting on a number of matters that represent substantial and less substantial changes. As well as asking whether respondents would support these changes we are also asking for views on when any changes we decide to make should be implemented. If we decide to change the principles, we could implement them from the start of the next electricity distribution price control in April 2010. Or we could consider them as part of our major review of our approach to network regulation through our "RPI-x@20" review that is due to report in the summer of 2010.

It is important to stress that any changes that are proposed as a result of this consultation, will not be intended to direct the trustees of the pension schemes to

[2] In GDPCR specific contribution rates were set rather than specific allowances

make particular decisions regarding the funding of those schemes. Those decisions are a matter for the trustees, and we do not regulate the pension schemes.

Our aim will be to assess whether the licensees as scheme sponsors are facing adequate incentives to mitigate and manage pension costs effectively. We are concerned about the risk of creating the wrong incentives - for example sponsors may take a more relaxed stance with trustees in allowing an excessively cautious funding strategy because of a belief that we will allow them to recover any additional costs from customers. There may, however, be a number of inbuilt protections against this risk. We are keen to understand the extent to which we can rely upon the fact that trustees are formally independent of the sponsor and that many of the schemes also include a significant number of members whose costs are funded by non-regulated businesses and as such have incentives to keep costs down.

We intend examining the evidence for what other companies in competitive markets who have been faced with similar schemes have done; and whether the incentives created by the current principles will encourage network companies to behave in the same way, if this is appropriate.

In the past year several large companies (e.g. Emap, Rank and P&O) have been involved in selling on their pension liabilities; as has a small section of the ESPS (Electricity Supply pension Scheme) relating to the defunct industry body, the Electricity Association Services Limited. If the terms and conditions are right it is possible that this could encourage other employers participating in the ESPS to consider a similar deal. We need to set out principles of how we would deal with this and make sure we put appropriate incentives on managements to consider whether this would be in customers' long term interests.

As part of this review, we are considering the appropriate treatment of stranded surpluses which might arise if there are very high levels of contributions. This surplus could be unavailable to consumers in the medium-term, since trustees may be unwilling to accept reduced contribution levels or returns of surplus at future reviews. If this occurred we are duty bound to consider how (or whether) the benefits of this surplus may be released to the consumers who have funded the surplus.

In considering changes to the pension principles, we only want to make changes that we think are in customers' interests. We recognise that doing so may change the balance of risk and reward for network companies and if it did, we would take this into account when setting future price controls.

We also discuss a number of more practical issues, including: setting an appropriate period for funding any deficit recovery payments; how pension costs and ex post adjustments interact with the Regulatory Asset Value (RAV); and the treatment of pension administration costs, including the PPF levy.

We welcome views on all these issues and any others that respondents think are relevant by 26 September 2008. In early October we will hold a seminar to discuss the issues raised in this document. Further details will be available on our website or from DPCR5.reply@ofgem.gov.uk. We will publish a DPCR5 policy paper in December 2008 and will incorporate the outcome of this consultation and our emerging thinking and conclusions on our pension principles in that document.

1. Introduction

Chapter Summary

This chapter sets out the purpose of the document, the background to our pension principles and reviews changes in the pension environment.

Purpose of the document

1.1. In setting price controls we make an allowance for the efficient level of costs we expect companies to incur over the period of the price control, including the costs companies incur to fund their employees' pension schemes. We set out our pension principles in the Developing Network Monopoly Price Controls consultation in May 2003 and have applied these with minor refinements through three price controls - DPCR4, TPCR4 and GDPCR. The principles are aimed particularly at defined benefit pension scheme costs.

1.2. Across the three price controls we set pension allowances which amount to an annual cost to consumers of £441 million, as set out in the table below. Defined contribution scheme costs were also included in overall opex and capex allowances but not separately identified.

Table 1: Ex ante defined benefit pension allowances by sector[3]
Normal & deficit average per annum

£m (2007/08)	Normal	Deficit	Total
DPCR4	96	145	241
TPCR4	74	56	130
GDPCR	45	25	70
TOTAL	**215**	**226**	**441**

Additionally, in the first three years of DPCR4 actual deficit repair payments and normal contributions by DNOs exceeded these allowances by around £63 million as a number of DNOs made significant lump sum deficit repair payments in the first two years covering the control period. The recent triennial valuations specify an increase in normal contribution rates from an average of 19 per cent to 22 per cent and additional deficit repair payments are to be made in the last two years of DPCR4 in excess of the allowances. In the first year of TPCR4 actual contributions were £37 million, as NGET has been in the process of a agreeing a recovery plan in respect of

[3] For GDPCR, there were further pension amounts embedded in our assessment of capex and repex, but these were not separately identified

the deficit expected in the valuation. Data for the first year of GDPCR is not yet available. Across the individual price controls it is anticipated that allowances will be exceeded despite ongoing deficit repair payments.

1.3. There have been significant developments since we set the pension principles, including the introduction of the Pensions Act 2004 and the Pensions Regulator and the PPF and changes in mortality and investment yield assumptions. Across the price control reviews, we have observed a sharp rise in employer contribution rates to defined benefit pensions schemes (ranges are DPCR4 14% to 20%, TPCR4 24% to 32%, GDPCR 31% to 39%) where these contributions are in line with those proposed by the scheme actuaries and approved by trustees and sponsors. The recent triennial valuations to 31 March 2007 of the Electricity Supply Pension Schemes (ESPS) of the English and Welsh DNOs have not shown such sharp increases as seen in transmission and gas distribution with a maximum of 26.3 per cent and an average of 22 per cent last year. However, DNOs and other licensees have indicated informally that pension deficits have increased significantly at 31 March 2008 over the previous year.

1.4. We have started the consultation process for the next electricity distribution price control (DPCR5) and are also beginning our review of the regulatory regime for energy networks (RPI-x@20). We think it is a good time to review how well the principles have worked to date and to consider improvements.

Types of Pensions schemes

1.5. A Defined Benefit (DB) Scheme is a pension scheme in which an employee's pension is based on number of years of service and final salary (or in newer schemes average salaries over the employment period) with sponsoring employer(s). Contributions are invested in a fund, and the scheme needs to be reviewed periodically (the main valuation exercises are typically triennial) to ensure that the value of the fund and the planned future contributions by both employer and employee are sufficient to meet the liabilities. This review must take into account the benefits of the scheme, expectations regarding future investment performance and expectations regarding life expectancy of the members. Depending on the conclusions of the review, the fund may be judged to be in surplus or in deficit, and the contribution rates may need to be adjusted. A surplus may create an opportunity to reduce contribution rates, whilst a deficit will require additional payments by the scheme sponsor and employees to eliminate it and ensure the solvency of the fund.

1.6. In the 1990s some of the funds sponsored by the licensees were in surplus and were able to reduce both the employee and the employer contribution rate. However, a decade later, with increasing life expectancy and a downturn in investment returns, the majority of funds were in deficit. Sharp increases in employer contribution rates were required (although employee rates did not always return to their original levels) as well as deficit repair payments. The increasing scale of defined benefit scheme pension costs led directly to Ofgem introducing pension principles as a mechanism to substantially protect the licensees from these risks.

1.7. A Defined Contribution (DC) Scheme is a pension scheme in which the benefits will be dependent on the contributions to and the investment performance of the scheme's assets. Employer contributions to DC schemes form an integral part of our assessment of total employment costs, which are within our determination of allowances for both operating and capital expenditure. By contrast with DB schemes employers' contributions costs are fixed and the sponsor bears no risk from shortfalls in investment returns nor does it have an obligation to fund deficits.

Background to the principles

1.8. Prior to DPCR4, we did not consider pension costs separately from other employment costs in setting the price controls. Pension costs were reviewed as part of operating costs (opex) and network investment (capex). Allowances were set which included pension costs and licensees bore the risk of over expenditure (and gained from any under expenditure) against these allowances. By the time we came to set DPCR4, it was apparent that a mechanism was needed to address that portion of the large deficit that had arisen which was attributable to the regulated distribution businesses[4].

1.9. To address the issues, we proposed a set of principles to ensure consistency and regulatory certainty, which have been applied to all network licensees over the past three years. We discuss these principles in more detail in chapter 2.

1.10. The principles are relevant principally to DB Pension Schemes rather than DC Schemes. Employer contributions to DC schemes form an integral part of our assessment of total employment costs. Conversely, for the reasons set out above, for DB schemes we have set separate allowances. The effect of this is essentially to allow licensees to pass through the cost of contributions to DB schemes to customers.

1.11. We allow ongoing pension cash costs for the regulated business within the overall allowance plus the cash funding of the deficit[5]. We expect companies and trustees to show reasonable prudence and proper commercial stewardship and costs should be able to be judged efficient. The spreading of deficits has been based on actuarial recommendations subject to being reasonable and prepared in line with normal actuarial practice. Generally, if the next actuarial valuation produces a lower deficit repair requirement then we would expect the licensee to reduce its payments accordingly.

[4] We have a duty under the Gas Act 1986 and the Electricity Act 1989 to set revenue allowances sufficient for an efficiently-operated licensee to finance their activities
[5] These cash costs are likely to differ from the pensions charge in the licensee's statutory accounts, which are prepared on an accruals basis

1.12. We recognise pension liabilities in accordance with the principles in chapter 2 for price control purposes. We obtain, review, compare and discuss with actuaries their valuations and assumptions to satisfy ourselves that they are reasonable and in line with industry best practice. Pension costs form a part of the overall allowed revenue, with an ex post adjustment for changes in cash costs as compared to ex ante assumptions. So whilst any overspend on pensions compared to the price control assumptions will reduce the balance of allowance for other costs, the difference (and the cost of financing this overspend) will be recovered in the subsequent price control period.

Changes in the pensions environment

1.13. The UK pension' environment has changed significantly since 2003. The Pensions Act 2004 introduced a new Pensions Regulator and the Pension Protection Fund Scheme (PPF), to which all funds have to contribute, thus increasing further the costs of operating a defined benefit scheme. Longevity is increasing as we see lower mortality rates. The Pension Regulator issued a consultation document in this area in February 2008[6].

1.14. We are also starting to see a trend towards pension schemes de-risking, either moving to more conservative investment strategies (i.e. bonds) or looking to hedge out longevity risks or possibly achieving both via a buy-out. This increased certainty comes at a cost, which under the current pension principles is liable to be passed on to customers. Some of these factors may be driven by the general pension environment, but we also consider the possibility that the principles themselves have had an effect.

1.15. Scheme-specific funding has been introduced in the ESPS, whereas previously this was dealt with by one actuary applying a common set of actuarial principles to all ESPS schemes. In the gas sector, the sale of four of the GDNs in 2005 resulted in a new set of defined benefit schemes created by transfer of relevant assets and liabilities from the Lattice Group Pension Scheme, all funded on an individual basis. There are a number of issues associated with scheme-specific funding, as follows:

- By definition scheme-specific funding can result in individual schemes using different actuarial assumptions which could in turn result in significant differences in the contribution rates of licensees. An issue is whether it is appropriate to normalise when we observe significant membership differences and variations in the strength of the employer covenant.

[6] 'Good practice when choosing assumptions for defined benefit pension schemes with a special focus on mortality', February 2008

- The three year cycle of valuations for pension groups may become more fragmented under scheme-specific funding. For example, individual licensee or scheme specific events may cause trustees to bring forward valuation dates. The most likely effect would be to increase costs earlier in one licensee group compared to others in the same sector and subject to the same price control.

1.16. The introduction of the PPF has brought additional costs in the form of scheme based and risk based levies to fund the PPF and the administration of it. These levies have been increasing and their magnitude is to some extent not within the control of the licensees or the trustees. Some steps can and have been taken by both where it is in their power to mitigate. However, as the PPF has to fund its liabilities it has necessarily amended its criteria where mitigation efforts by trustees and companies mean the required level of funding has not been received. Potentially at issue is whether any mitigation steps just defer payment across time or whether permanent savings can be achieved.

Way forward

1.17. We review whether these and other developments are adequately catered for under the existing principles, examining alternative approaches (Chapter 3) and application issues which have arisen in practice (Chapter 4).

1.18. We recognise that the RPI-x@20 review could fundamentally change the way in which we regulate the distribution and transmission businesses. As such there may be arguments against a radical change in the treatment of pension costs and liabilities for DPCR5 given that pensions may get subsumed in broader regulatory changes from 2011 onwards. However, we need to weigh this against the concerns we have about rising pension costs and what seems to be the limited incentives on licensees to mitigate these costs. These concerns might suggest we need to do something sooner, even if it is only for a transitional period.

1.19. In arriving at any decisions, we will carefully consider the responses to this consultation before we make any changes to the principles or the way we apply them. We will consider which of them should be implemented from April 2010, which marks the start of DPCR5, and what issues should be considered further through the RPI-x@20 project, which is due to report in summer 2010. We will take into account our aim to create effective incentives on network companies to efficiently manage the rising cost of defined benefit schemes that other companies who operate in competitive markets have faced. We only want to make changes that we think are in customers' interests, but we recognise that doing so may change the balance of risk and reward for network companies and if it did, we would take this into account in setting future price controls.

2. The principles

Chapter Summary

This chapter sets out the background to the development of the principles and the principles themselves.

Background

2.1. The central concept to our approach to the treatment of pensions within price controls is to have a "core" set of consistently applied principles to all distribution and transmission licensees to bring regulatory certainty. These principles were first discussed in *Developing Network Monopoly Price Controls May 2003*[7] document to which reference may be made.

2.2. The principles are as follows:

- Licensees can recover economic and efficient salary and pension costs;
- Licensees can recover the attributable regulated fraction only;
- Ex-ante adjustments to allowances may be made where there has a failure in stewardship;
- Pension costs will be assessed using actuarial valuation;
- Adjustments will be made to allowances for under funding / over funding;
- The additional cost of Early Retirement Deficiency Contributions will be borne by the licensee.

2.3. They formed the basis of the approach to pensions in DPCR4 and with some evolution, in the TPCR and GDPCR controls. The principles are always applied in the context of the specific price control review and in line with our principal objective, which is to protect the interests of consumers having regard to our wider statutory duties and any relevant European obligations. Thus exceptions or amendments to the principles have been made where appropriate.

2.4. Issues that we consider when assessing the appropriate specific allowance to make for pension costs include:

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

- How the pension schemes of sponsor companies compare in practice with those offered by companies operating in competitive markets;
- If the pension scheme is in deficit (surplus), how this has arisen or is expected to arise, including the nature of the deficit (surplus), i.e. whether it is permanent or expected to be short lived;
- The impact that funding a pension scheme deficit may have on the financial position of a company; and
- External forces and controls that will affect the Scheme including the Pensions Act 2004, The Pension Regulator and PPF interaction.

Existing six principles

Principle 1 - Efficient and Economic Employment and Pension Costs

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

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

2.6. Following review, we have in practice allowed all pension cash contributions in the last three controls. There is a risk that if the companies know they will have their actual pension cash costs guaranteed and met through the price control allowance there may not be the incentive to explore alternative funding bases apart from the conservative basis proposed by the trustees and their actuary. This is discussed further in Chapter 3.

Principle 2 - Attributable Regulated Fraction Only

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

2.7. It is for shareholders, rather than consumers, to fund liabilities associated with businesses carried on by the wider non-regulated group. This includes businesses that were formerly carried on by the same ownership group and have been sold, separated and / or ceased to be subject to a Price Control review. In principle this may include de minimis business and excluded services in the context of a transportation and distribution price controls. However, in some cases the costs of such businesses are not readily separable from the regulated business and so they are dealt with on a case by case basis.

2.8. At DPCR4 there was a general assumption of a 20% disallowance for non-regulated activities for most licensees. At TPCR4 only the proportion of ongoing contributions and existing deficit that related to unregulated activities was disallowed. In GDPCR a small adjustment was made in respect of pensions relating to the metering business.

Principle 3 – Stewardship - Ante/Post Investment

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

2.9. Any excess costs arising from material failure in the responsibility for taking good care of pension scheme resources so entrusted will be disallowed. Examples might include items such as recklessness, negligence, fraud or breach of fiduciary duty.

2.10. In determining whether pension costs are reasonable, we compare the level of funding rate recommended by periodic actuarial valuations to the actual funding rate adopted by the licensee. As long as a funding valuation uses actuarial assumptions which are in line with best practice the costs will be allowed in full. This is one indicator of whether there has been no material failure in stewardship. We also examine investment and administration costs to see whether these are materially out of line with industry figures.

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

Principle 4 - Actuarial Valuation / Scheme Specific Funding

Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice. Allowances are based on the cash funding rate recommended by the most recent full actuarial valuation

2.12. We expect the level of scheme funding to be assessed on the basis of forward looking assumptions regarding long-run investment returns and other key variables. Licensees are required to provide up-to-date actuarial calculations (including the

most recent formal actuarial valuation of the relevant schemes) to support their cost estimates.

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

2.14. Trustees must obtain an annual update of the financial position.

2.15. The Pensions Regulator's scheme funding will be examined as part of the Price Control Reviews.

2.16. The allowance for pension costs at each price control review will be based on the cash funding rate recommended by the most recent full actuarial valuation then available for each company's scheme.

Principle 5 - Under Funding / Over Funding

In principle, each price control should make allowance for the ex ante cost of providing pension benefits accruing during the period of the control, and similarly for any increase or decrease in the cost of providing benefits accrued in earlier periods resulting from changes in the ex ante assumptions on which these have been estimated (Ex Ante and Ex Post)

2.17. Typically, actuarial valuations of pension funds are carried out triennially. In contrast, price controls are typically set for periods of five years. Accordingly, it is possible that funding rates may change during the period of a price control. In practice with the change to scheme-specific funding it is possible that individual or scheme specific events may bring forward valuation dates. For example, the reorganisation of the United Utilities section of the ESPS required a specific valuation prior to the sale of what is now Electricity North West, as a consequence the triennial valuation was deferred one year to 2008.

2.18. We will log up the cumulative effect and pass the impact through to consumers when setting the price control at the subsequent review.

2.19. Adjustments will be made only in respect of ex ante assumptions which are outside the control of the sponsor, e.g. mortality assumption changes, membership, market movements and legislation.

2.20. We will reflect differences (if any) between the allowances made in setting previous price controls and the actual employer contributions made to pension funds in the same periods.

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

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

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

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

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

2.26. It is of course difficult in practice to make judgements about the reason for increases or decreases in costs. For example, in GDPCR, we dealt with the issue by taking the line that ex post adjustments would be carried out by reference to the difference in the ongoing contribution rates multiplied by the actual pensionable salaries.

2.27. Increases in pension costs against allowances will therefore in general be recoverable from (or decreases recaptured for) consumers on an NPV-neutral basis.

Principle 6 - Severance - Early Retirement Deficiency Contributions

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

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

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

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

- To the extent that actual contributions in any period fall short of or exceeded the assumed contribution, the amount of the shortfall or excess needs to be rolled forward to the date of the actuarial valuation on which the future price control allowance is based. We consider this should be done by assuming a total return in line with the scheme specific ex post returns typically earned by the funds in the relevant period(s); and

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

Defined Contribution Pension Schemes

2.31. The principles are particularly relevant to DB scheme costs. We typically benchmark costs including DC schemes, which approach effectively covers the application of the first principle. As we do not assess DC scheme costs by reference to the scheme itself, we do not in practice have to consider principle 2 (i.e. such non-regulated business costs are automatically excluded by the way we assess costs generally). Since DC contribution rates are not directly driven by actuarial assumptions or investment performance, principles 3 and 4 are not applicable. Since deficits do not arise on DC schemes, nor do contribution rates have to rise as a result of actuarial assumptions, we do not have to consider under/over recovery. To the extent that severance or early retirement costs include defined contribution costs, we do not pay for them, but in practice this does not require specific consideration as we do not make ex post adjustments for DC scheme costs in any case.

3. Alternative approaches and new issues

Chapter Summary

This chapter sets out the issues with the current pension principles and considers what alternative approaches could be taken, including changes to the treatment of stranded surpluses and the buy-out of scheme liabilities.

Question 1: Have we identified the key issues with the current pension principles?
Question 2: Do the principles need amending and, if so, what changes are required?
Question 3: Which issues should be addressed as part of DPCR5 and which issues are better dealt with as part of the RPI-x@20 review?

Efficient costs

3.1. A key issue to be addressed at any price control is whether, inclusive of pensions, employment costs are in line with market rates. Currently, cash pension contributions relating to service within the price control period are reviewed as part of total costs, and then, based on the forecast level of contributions reviewed as a proportion of underlying salaries to identify the explicit pensions allowance within the total opex and capex allowances. There have been varying approaches to normalising pensions in the different price controls, dependent on the mix of defined benefit and defined contribution schemes and the levels of in-sourcing and out-sourcing to contractors. The pension principles state that these cash costs of servicing defined benefit schemes will be allowed in full, subject to being reasonable and prepared in line with normal actuarial practice.

3.2. At GDPCR, proposed funding costs were higher than our experience at previous price controls. We reviewed the assumptions used by the GDNs' actuaries and found no evidence that they were not reasonable and in line with normal actuarial practice; nor that there had been a failure of stewardship in respect of the scheme management for any of the schemes. Indeed across the regulated businesses the past valuation bases, whilst conservative, have not appeared to be significantly out of line with the range adopted by UK schemes in general. Companies do not appear to have adopted excessively conservative assumptions in the past. This may be because it is only recent developments in actuarial valuation methodology, in pension legislation and market fluctuations that have had the effect of increasing substantially the values actuaries now place on pension liabilities. Nevertheless, the total level of funding required by GDNs to meet these cash costs led us to consider whether the application of certain of the pension principles should be reviewed to reflect changing circumstances. All GDNs provided final or draft proposed actuarial contribution rates. The contribution rates and funding levels for the GDN defined benefit schemes were as follows:

Table 2.2: GDN Proposed Funding Rates

Licensee (scheme)	NGG	NGN	Scotia	WWU
Future accrual contribution rate	31%	31%	37%	39%
Past accrual funding level	97%	85%	77%	82%

3.3. These variances in GDNs are despite the schemes having the same benefit packages, and being funded at the same level at 31 May 2005. Some of the variances are due to differences in valuation dates, funding rates and the level of benefits. For comparison, average future accrual contribution rates for electricity TOs, which were performed at approximately the same date, were between 20 to 30 per cent, and the government review of UK schemes as a whole indicated a UK average contribution rate in 2005 of 16 per cent, an increase of 1.5 per cent year-on-year on 2004[8].

Table 2.3 TPCR4 actual funding rates

Licensee (scheme)	NGGT	NGET	SPT	SHETL
Employer contributions	30.2%	20.6%	23.0%	25.0%

Table 2.4 ESPS/principle Scottish schemes
Electricity distribution contribution rates over time

	last valuation	04/05	05/06	06/07	07/08	08/09
CN West	31-Mar-07	18.1%	16.7%	16.8%	16.8%	23.1%
CN East	31-Mar-07	15.5%	16.9%	16.8%	16.8%	23.1%
ENW/UU	31-Mar-04	17.6%	20.2%	20.2%	20.2%	20.2%
CE NEDL	31-Mar-07	13.6%	20.6%	20.6%	20.6%	26.3%
CE YEDL	31-Mar-07	14.0%	20.6%	20.6%	20.6%	26.3%
WPD S Wales	31-Mar-07	13.9%	18.5%	18.5%	18.5%	21.1%
WPD S West	31-Mar-07	13.9%	18.5%	18.5%	18.5%	21.1%
EDFE LPN	31-Mar-07	17.3%	18.3%	18.3%	18.3%	20.2%
EDFE SPN	31-Mar-07	17.3%	18.3%	18.3%	18.3%	20.2%
EDFE EPN	31-Mar-07	17.3%	18.3%	18.3%	18.3%	20.2%
SP Distribution	31-Mar-06	15.0%	15.0%	15.0%	15.0%	15.0%
SP Manweb	31-Mar-07	14.1%	14.1%	15.8%	15.8%	20.3%
SSE Hydro	31-Mar-06	20.0%	20.0%	23.8%	27.5%	27.5%
SSE Southern	31-Mar-07	19.9%	19.9%	20.6%	20.6%	23.4%

Tables 2.2, 2.3 and 2.4 demonstrate the underlying variations in the level of employer contributions. This has contributed to our concerns as to whether the principles are working and to review whether it continues to be appropriate to accept all the assumptions used by scheme actuaries when we set price control allowances.

3.4. Our primary duty is to protect consumers' interests and we are concerned about the risk of creating a perverse incentive for sponsors to take a more relaxed stance with trustees in allowing an excessively cautious funding strategy because of a belief that we will allow any costs that arise. While we recognise that the trustees are independent of the sponsor, in a competitive environment they would be expected to

[8] "Occupational Pension Schemes, 2005", Government Actuary's Dept, p. 94.

take into consideration an employers' ability to fund contributions. We also recognise that schemes include both non-regulated and regulated members and as such there is likely to be some incentives to keep costs down.

3.5. Views are invited on whether the management and risk and rewards of current and future pension liabilities should be transferred to licensees and not be subject to ex post adjustments. Would this benefit consumers without unduly increasing the risk for shareholders who would then be encouraged to mitigate their risks?

Buy-out of scheme liabilities

3.6. In the past year several large companies (e.g. Emap, Rank and P&O) have been involved in selling on their pension liabilities, as has a small section of the ESPS relating to the defunct industry body, the Electricity Association Services Limited. The latter was bought out by Legal & General for £182 million. If the terms and conditions are right it is possible that this could encourage other employers participating in the ESPS to consider a similar deal.

3.7. We are concerned that the current principles may not give companies an adequate incentive to consider selling on their pension liabilities where this would be in customers' interests. If it is found that there are insufficient incentives one potential option might be for Ofgem to require sponsors and trustees to crystallise their liabilities by running a competition to buy out the liabilities. After a buy out, there would be no separate allowance for pension costs and licensees would be subject to the same incentives to manage pension costs as overall employment costs.

3.8. Similarly, if it was felt that selling on pension liabilities could minimise future costs for customers, this could also potentially be achieved by a notional crystallisation of liabilities as part of a regulatory settlement. Funding may still have to be allowed as a result of changes in future assumptions, market prices, or movements of actives to retirees post the crystallisation date. Either course of action would need to consider the protection afforded by the Electricity Act 1989 and Gas Act 1986 to certain pension scheme members at the time of privatisation and, if necessary, the cost of buying that out.

3.9. While either of these approaches may have the benefit of improving incentives and transferring the risk of pension cost overrun from customers to the licensees, they could involve additional contributions (dependent on a scheme's solvency position at the time). Depending on the regulatory treatment of these additional contributions, could accelerate the pension burden for consumers.

3.10. We recognise the pension principles do not address the treatment of any costs associated with a buy-out and that this in itself may deter companies from considering selling on their liabilities.

3.11. Views are invited on whether:

- the current principles provide incentives for companies to explore whether a buy out would be a good idea and in customers' interests and if not, should they; and how do we encourage licensees to review this option?
- if the current principles are not sufficient, what are the principles that we should set out; and, how we should deal with buyouts?
- it is appropriate to address this issue now or to consider it as part of the RPI-x@20 review
- applying the existing principles is it appropriate for consumers to fund the cost of additional contributions required on buyout; or should they be for the acquirer or existing shareholders, as the costs may not necessarily satisfy principles 1 and 5; and
- if the cost of crystallisation satisfied the principles it should be spread over an appropriate future period to minimise the impact on consumers (on an NPV-neutral basis)

3.12. We recognise that the RPI-x@20 review could fundamentally change the way in which we regulate and, as such, there may be arguments against a radical change in the treatment of pension liabilities for DPCR5, especially the buy-out options, as pensions may get wrapped up in broader regulatory changes from 2011 onwards. As previously stated, we will carefully consider the responses to this consultation before we make any changes to the principles or the way we apply them. We will also consider responses before deciding which of them should be implemented for DPCR5 and what issues should be considered further through the RPI-x@20 review.

Scheme valuation bases

3.13. Our principles state that the valuation bases should be in line with normal actuarial practice. Our reviews of pension scheme valuations at previous price controls have shown that they are all consistent with normal practice, although the underlying assumptions used have varied. Differences in assumptions have increased following the change to scheme specific funding. There is a tendency to move to more cautious funding bases under this new regime. This has led to increased contributions, which in turn has led to increase pension allowances.

3.14. The bases applied in the most recent electricity distribution actuarial valuations are:

- Funding method adopted is the Projected Unit method as the basis used to calculate the Technical Provisions.
- Income rate is the yield on long dated gilts of 4.7 per cent plus an amount for the prudent view of the expected outperformance (above gilt returns) of the scheme's assets. The latter amount varies between 1.3 and 2.0 per cent.
- Life expectancy in all cases is based on scheme specific rather than the long cohort suggested by The Pensions Regulator in his February 2008 consultation. All actuaries state that since the previous valuations, life expectancy is improving much faster than previous research envisaged. Mortality assumptions have been revised with male lives increasing by an average of 3 years and female lives

slightly less, although there is a wider variance of female mortality across schemes of 86.7 to 92.3 years.

3.15. We need to give further consideration to how we should deal with significant variations in valuation bases, particularly where this results in widely varying (and increasing) contribution rates. The strong employer covenant in regulated businesses is regarded, amongst others, as one of the reasons for the pension schemes using different assumptions and different deficit recovery periods. However, given the variations and the general rise in contribution rates, we are now considering whether we should set our own bases to be applied consistently across all licensees in considering the allowances.

3.16. This issue was reviewed by Kerr & Company for both TPCR4 and GDPCR and we concluded at that time that there was no evidence that the scheme specific actuarial recommendations were outside the margins of reasonable actuarial practice. We recognise that pension costs, where incurred in line with our principles, will be funded at some point and any common valuation basis that could be applied consistently would only shift the burden across different generations of consumers, although they may be circumstances where this may be justified. If we were to claw back the benefit of any over funding which has resulted in a surplus, then adopting a common valuation basis may only lead to additional complication at each review and in computing ex post adjustments and increase costs. However this alone may not preclude such an approach. There may also be an offsetting impact on the cost of capital and financeability.

3.17. At present the application of the principles has meant using the last fully complete triennial valuation before the conclusion of the price control review. At times of changes and volatility in the economic climate, licensees have suggested that they would provide interim valuations where these might show significant movements in funding requirements to inform the setting of allowances. There is a concern that sponsors may only have such interim valuations prepared where the market conditions and other factors (e.g. RPI, investment returns) have moved adversely for them, in order to boost the ex ante allowances. If we intend to make full ex post adjustments as per the principles, this is purely a matter of timing but which could defer full funding until a subsequent price control. However, if we move to a different basis of funding licensees' pension costs, this might have a genuine cash impact. If later actuarial valuations (e.g. interim valuations) become available should we use them in our assessment of pension allowances; and, should all sponsors in a control be required to prepare them for the latest data to be applied fairly and consistently across a sector?

Future funding and stranded surpluses

3.18. There is particular concern that excessively cautious funding strategy could lead to stranded surpluses and therefore increased costs (and prices) borne by customers. A stranded surplus could arise, in the future, from very high levels of contributions and which is unavailable to consumers in the medium-term, since trustees may be unwilling to accept reduced contribution levels or returns of surplus

at future reviews. If this occurred we are duty bound to consider how (or whether) the benefits of this surplus may be released to the consumers who have funded the surplus. We indicated in the GDPCR Initial Proposals that we would review this further.

3.19. Our principles state that deficits (including the difference between allowed and actual contributions) will be funded, but that equally the benefits of a surplus should be passed back to consumers. Our current approach is that to the extent that a surplus arises in future, there will be an ex post review of whether that surplus has arisen as a result of accelerated contribution rates. If so, then in principle we consider that surpluses should be used for the benefit of consumers to reduce future contribution rates so long as this is consistent with any relevant legal obligations - whether arising from pension's regulation or otherwise. The principle behind this approach is that we expect that surpluses would be treated symmetrically to deficits, i.e. that if consumers are to fund deficits, then they should also get the benefits of any surplus.

3.20. It has been our provisional view, subject to this consultation (and without fettering future decisions of the Authority) that, in such circumstances, it would be appropriate that the surplus be spread on a similar basis to that applied to deficit repair costs. Under the principles it is only a timing difference when spreading deficits or surpluses for the benefit or detriment of different generations of consumers.

3.21. We invite views on this approach and what may be the appropriate period over which the reduction should be spread.

4. Application issues

This chapter focuses on a number of application issues, including the appropriate deficit recovery period and the treatment of a full payment of a deficit for consumers; options for calculating ex post adjustments; the interaction between pension costs and RAV; how pension scheme administration cost, including the PPF levies, should be treated; the impact of merging schemes in attributing costs and liabilities between regulated and non-regulated businesses; and the impact of takeovers on pension costs.

Question 1: Should we set a generic deficit funding period, e.g. maximum assumed by the Pension Regulator, or accept that proposed by the individual scheme actuaries?
Question 2: Views are invited on the approach to the treatment of full funding of a deficit and what alternatives there are to ensure consumers are not disadvantaged in any given price control period?
Question 3: Should ex post adjustments be calculated by reference to the amount of the allowance, which takes no account of the impact of changes in defined benefit salary scheme costs, or by reference to the contribution rate, which automatically adjusts for such changes?
Question 4: What are respondents' views on the capitalisation of pension costs into RAV; and, whether there are any circumstances in which normal and deficit repair costs should be treated differently for RAV?
Question 5: Are any steps taken to mitigate the risk based element of the PPF levy just deferring payment across time or can permanent savings be achieved?
Question 6: Views are invited on the treatment of pension scheme administration costs (including the PPF levies) to ensure consistency, whether they should be subject to an efficiency review; and the treatment in RAV.
Question 7: Where schemes have been merged should issues arising from applying the principles be dealt with on a case-by-case basis or should rules be developed to provide guidance?
Question 8: Should it be obligatory to require an actuarial assessment of ongoing contributions and deficit repair payments to the individual constituent regulated and non-regulated businesses?
Question 9: Where a licensee is taken over do the principles effectively deal with the treatment of any additional pension deficit repair payments?

Deficit recovery periods

4.1. Deficit recovery periods are set out in Principle 5. Until recently, recovery of deficit costs attributable to licensees was normally computed (by us when setting allowances) over the average remaining service life of the active membership. As such at DPCR4 all repair periods were set at 13 years with one exception, whose remaining service life was 10 years. By comparison, at GDPCR and TPCR4 we allowed the costs of payments over a 10 year period to close the pension deficits in

each GDN's pension fund and indicated we would review this at the subsequent price control review. Since DPCR4, the Pensions Regulator has issued regulations[9] indicating a ten year trigger for recovery plans but makes clear that this trigger is not a target or a standard for the length of a recovery plan. It does not intend to focus its attention on schemes where the recovery period is set at less than ten years unless it has reason to believe that assumptions used may be inappropriate or where the strength of the employer's covenant is believed to be deteriorating.

4.2. The Pensions Regulator has made it clear that it will be flexible when considering recovery plans. In deciding whether to take action where a recovery plan has triggered, that regulator has stated that full regard will be given to the impact any change to the recovery plan may have on the employer's viability, including its ongoing ability to fund the scheme and its long term health.

4.3. Based on the recent triennial valuations of the English and Welsh DNOs ESPS schemes, deficits are being recovered between 3 years 3 months to 8 years with an average of 5 years 10 months, as recommended by scheme actuaries and accepted by trustees and sponsors. In some cases the payments are front end loaded into the remaining years of DPCR4. This may be evidence of a strong employer covenant and/or of the assumption that the pension principles will allow these costs in full through ex post adjustments.

4.4. We invite views on whether we should make allowances in line with shorter deficit funding periods where recommended by the actuaries and accepted by the companies and trustees; or set a generic recovery period, which may be the maximum 10 year trigger assumed by the Pensions Regulator, in order to smooth the payments made by consumers. Is it appropriate that there should be consistency across different licensees and differing groups of consumers?

Full payment of deficit

4.5. The principles address the extent to which actual cash pension contributions differ from the pension allowances and how they will be offset against any future pension costs[10], i.e. by converting over- or under-spend relative to the allowance into a pass-through at the next review. However, this expressly only covered lump sum payments insofar as they relate to deficit repair payments otherwise due in the price control period, i.e. not to full payment of the deficit. We are guided by our statutory duties to ensure that consumers are not disadvantaged relative to the position they would have been in had a company made more regular payments. We

[9] Part 3 of the Pensions Act 2004 (Scheme Funding) and the Occupational Pension Schemes (Scheme Funding) Regulations 2005 (SI 2005/3377).

[10] Distribution Price Control Review 4 – Final Proposals (265/04) at paragraph A1.47.

expect to set pension allowances such that companies (and their shareholders) are not disadvantaged by any advance payment of pension contributions during a price control period, provided or to the extent that this can be achieved while holding consumers neutral on an NPV basis.

4.6. Under currency policy, insofar as an element is capitalised in the RAV this would be added to the RAV in the year in which the payment is made. Of the remainder of the lump-sum that would have fallen due after the end of the current control period, i.e. applying our standard deficit recovery period, we would review the situation at the next price review and if customers would otherwise be benefiting from the lump-sum having been paid via lower pension allowances, we would provide for the licensee to be reimbursed. Entitlement to reimbursement of this element of the payment would be capped to ensure customers were not paying any more than they would have paid if the company had not made the payment. Any reimbursement not recoverable by the company would be carried forward to the following price review. Effectively this impacts on the timing of the recovery. This would need reviewing were we to follow actuarially recommended deficit funding periods rather than setting a standard period.

4.7. Views are invited on this approach and to suggest alternatives to ensure consumers are not disadvantaged in any given price control period.

Ex post adjustments for ongoing contributions

4.8. In DPCR4 and TPCR4 we set specific ex ante pension allowances, to which we will compare actual defined benefit scheme adjustments. This means that where a company has reduced its DB salary costs compared to the assumptions used in setting the allowances, other things being equal, its pension payments will have been reduced. It will benefit from the saving on the salary costs, but not on the pension element of those labour costs, because of the ex post adjustment (and the converse is true where DB salary costs have increased). This weakens the incentive to find such savings, although at present the opex incentives in the price control are still relatively strong.

4.9. In principle we have the option of adjusting the ex post allowances to reward licensees for efficiency or penalise them for inefficiency. In practice it is difficult to make judgements about what has led to the lower DB salary costs - for example if members of the DB schemes have left the company but have been directly replaced by new staff with DC pensions, there is no overall efficiency gain.

4.10. In GDPCR we changed the terms of the ex post adjustment so that we set an ex ante contribution rate. This will be compared to the actual required contribution rate and the difference will be multiplied by the actual DB salary costs, thus preserving the incentive effects of labour efficiencies. Views are invited on which approach is preferable.

RAV treatment

4.11. At DPCR4, in setting proposed revenue allowances, we capitalised 57.7 per cent of total pension costs. This reflected the average level of capitalisation of employment costs across the DNOs. At the time a number of DNOs argued against capitalising a proportion of pension costs relating to existing deficits, stating that this extended the period over which these deficits would be funded beyond the timescales in which the scheme trustees would require the relevant contributions to be made. They also argued that they were unlikely to be able to capitalise the deficit contributions in their accounts. One DNO accepted that capitalising a proportion of the deficit was a reasonable approach provided the DNOs were allowed an appropriate cost of capital. We considered these issues but concluded that capitalising a proportion of total pension costs was a reasonable approach. The companies will earn a return equal to the cost of capital assumption on the costs capitalised and included in the RAV and will therefore be in a position to finance any mismatch of timing between contributions and allowed revenues.

4.12. At DPCR4, all pension allowances (including deficit repair costs) were partly funded on a pay-as-you-go basis and partly by RAV additions. The latter has the same outcome as pay-as-you-go funding as RAV balances are, for price control purposes, amortised over a period of years during which the unamortised balance earns a return equal to the estimated weighted average cost of capital to the licensee. This provides the licensee with a revenue stream having the same NPV (on a pound for pound basis) as pay-as-you-go funding.

4.13. At TPCR4, in their specific circumstances, where there were no comparators of equal size, company specific capitalisation was considered the most appropriate and precise approach for that review. The proportion of pension costs capitalised ranged from 0 to 64 per cent[11].

4.14. At GDPCR, the amounts of pension costs capitalised were a much smaller proportion of total costs due to the contracting out model adopted in the industry. Although normalised pension costs were included in setting capex allowances, no separate allowances were made and no provision for ex post adjustments was made for these costs. Any over or underspend arising due to fluctuations in pension funding requirements will be largely mitigated by the capex incentive. In contrast to DPCR4, pension deficit funding payments were funded on a pay-as-you-go basis spread over 10 years. Compared to DPCR4 the funding requirements were not as significant and capitalisation was not an issue.

4.15. The options for treatment of capitalised pension costs include:

[11] NGG - 0%, NGET- 25%, SHETL - 48%, SPT - 64%

- Capitalisation of all DB pension costs (both normal employer contributions and deficit repair payments) should follow the price control treatment of employment costs into RAV.
- Deficit repair costs should be excluded from the RAV so that the licensee is remunerated for them in line with the deficit recovery period agreed for the price control.
- All DB pension costs should be remunerated on a pay as you go basis, since costs added to the RAV attract a return based on the risks associated with capex, and the pension principles effectively de-risk pension costs.
- Where the proportion of DB pension costs capitalised is relatively small, and there is a capex incentive rate that largely mitigates the effect of under/over funding, no specific ex post adjustment should be made for capitalised pensions.

4.16. Views are invited on these options.

Pension scheme administration costs

4.17. Pension administration costs include the fund manager's investment and other attributable costs. These may or may not include the PPF levy, dependent on whether they are paid by the sponsor or the scheme trustees and have not been treated consistently across price reviews. At TPCR4 we allowed the PPF Levy and administration costs in full; whereas in GDPCR any contribution were reviewed for efficiency and an allowance set on a case by case basis accordingly.

4.18. In DPCR4, administration costs were not separately considered or benchmarked from pension contributions or operating costs. As a consequence, there is an inconsistent treatment of administration costs across DNOs arising from how they are funded. Where these are funded by normal pension contributions and paid by the pension trustees they followed the treatment of those normal pension and deficit repair costs in computing RAV in the respective price controls. Where they are paid by and form a part of the indirect operating costs of the licensee they follow the treatment of such costs and have been subject to normalisation and benchmarking as part of business support costs. Where the administration and PPF levy is paid by the trustees then 57.7 per cent of total pension cost was allowed into RAV, being effectively a pass through. Whereas, if paid by the licensee only 52.57 per cent of total pension cost flow into RAV; and the balance being opex, is not treated as a pass through of costs.

4.19. The Pensions Regulator has been developing its rules for the PPF levy, which now consists of two elements – scheme and risk-based. The risk based element is calculated by reference to the level of funding of the scheme and to the strength of the employer and currently forms 80 per cent of the total. The scheme based levy is calculated by reference to the value of the total scheme PPF liabilities and currently forms 20 per cent of the total. There is a requirement for each pension scheme to complete a PPF valuation (Section 179 valuation) by 31 March 2008.

4.20. The size of the two levies has been increasing over time and, dependent on the PPF's funding requirements is not fully within the control of licensees. We have

observed that where they can licensees and trustees have been taking appropriate action to mitigate the risk-based levy, and on this basis we have allowed such costs in full to date, where accounted for by the licensee. One aspect of this mitigation has been accelerating deficit repair periods so there is a small correlation with the levy.

4.21. In setting allowances should we provide for both the scheme and risk based elements, or in view of the potential fluctuations in the size of the levy, should we provide ex post adjustments for administration costs including one or both elements of the levy? If so, should this be dependent on an efficiency review?

4.22. We consider that the principles should be amended to equalise the treatment of all pension administration costs in both setting allowances and computing RAV. Views are invited on the most appropriate methodology for this, for example:

- Should such costs be subject to an efficiency review independent of that for total employment costs (applying principle 1)?
- Should they follow employment or pensions costs (if different) into RAV, noting that RAV additions are computed differently (to accommodate varying sector circumstances) in each control?
- Should the PPF Levy be treated differently from normal pension contributions and if so should there be the same treatment for the fixed and scheme based element?

Merged schemes

4.23. Since the principles were promulgated, schemes have been merged and demerged following ownership changes. When schemes merge it can be difficult to ascertain what element of normal and deficit repair costs are attributable to the regulated businesses and no consistent approach has been formalised to guide licensees and trustees in this process as to how these will be treated.

4.24. Since 2003, NGG has demerged schemes for the new GDNs, E.ON has merged four schemes, EDF Energy has merged three schemes, United Utilities has reorganised its schemes following the sale of Electricity North West. There have also been other smaller mergers.

4.25. In broad terms we have allowed the licensees, often supported by scheme actuaries, to determine the level of contributions and deficit costs for the amounts attributable to the regulated business. The most appropriate time to review the impact of pension scheme mergers is at a price control as this is when we set the ex post adjustments, notwithstanding the publication in annual Cost Reviews of indicative RAV. It may be appropriate for us to consider obtaining independent assessment on the ex post costs. DPCR5 will be the first time that we have had to assess ex post adjustments.

4.26. Views are invited on whether these issues should be dealt with on a case-by-case basis or whether specific rules should be developed. If so what should those rules should be. In particular, where schemes have merged subsequent to the agreement of allowable percentages for regulated business at a previous control, should it be obligatory to require an actuarial assessment of ongoing contributions and deficit repair payments to the individual constituent regulated and non-regulated businesses?

Takeovers and their impact on pension costs

4.27. If a licensee or a group containing a licensee is taken over and the pension trustees require additional pension deficit repair contributions as the price of agreeing the takeover should those costs be allowed if they follow the principles, or should they be reviewed, on a case-by-case basis, in order to protect consumers? Views are invited on whether this is effectively covered by the principles.

Appendices

Index

Appendix 1 - Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. In particular, we would like to hear from consumers and their representatives, employees and trade unions, electricity and gas distribution network operators, transmission network owners and operators.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 26 September 2008 and should be sent to:

Bill McKenzie
Senior Manager, Financial Issue, Distribution, Networks
Distribution, Networks
Ofgem, 2nd floor, 9 Millbank, London SW1P 3GE
020 7901 7220
William.mckenzie@ofgem.gov.uk

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

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

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to publish its initial view on any changes to the pension principles in the next DPCR5 Policy Paper. Any questions on this document should, in the first instance, be directed to:

Bill McKenzie
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CHAPTER: Three

Question 1: Have we identified the key issues with the current pension principles?
Question 2: Do the principles need amending, and if so, what changes are required?
Question 3: Which issues should be addressed as part of DPCR5 and which issues are better dealt with as part of the RPI-x@20 review?

CHAPTER: Four

Question 1: Should we set a generic deficit funding period, e.g. maximum assumed by the Pension Regulator, or accept that proposed by the individual scheme actuaries?
Question 2: Views are invited on the approach to the treatment of full funding of a deficit and what alternatives there are to ensure consumers are not disadvantaged in any given price control period?
Question 3: Should ex post adjustments be calculated by reference to the amount of the allowance, which takes no account of the impact of changes in defined benefit salary scheme costs, or by reference to the contribution rate, which automatically adjusts for such changes?
Question 4: What are respondents' views on the capitalisation of pension costs into RAV; and, whether there are any circumstances in which normal and deficit repair costs should be treated differently for RAV?
Question 5: Are any steps taken to mitigate the risk based element of the PPF levy just deferring payment across time or can permanent savings be achieved?
Question 6: Views are invited on the treatment of pension scheme administration costs (including the PPF levies) to ensure consistency, whether they should be subject to an efficiency review; and the treatment in RAV.
Question 7: Where schemes have been merged should issues arising from applying the principles be dealt with on a case-by-case basis or should rules be developed to provide guidance?
Question 8: Should it be obligatory to require an actuarial assessment of ongoing contributions and deficit repair payments to the individual constituent regulated and non-regulated businesses?
Question 9: Where a licensee is taken over do the principles effectively deal with the treatment of any additional pension deficit repair payments?

Appendix 2 – The Authority's Powers and Duties

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

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts[12].

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly[13].

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

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

- The need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- The need to secure that all reasonable demands for electricity are met;
- The need to secure that licence holders are able to finance the activities which are the subject of obligations on them[14]; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas[15].

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

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

- Promote efficiency and economy on the part of those licensed[16] under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- Protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity;
- Contribute to the achievement of sustainable development; and
- Secure a diverse and viable long-term energy supply.

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

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

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation[17] and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

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

Appendix 3 - Glossary

C

Capital Expenditure (Capex)

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

D

Defined benefit (DB) pension scheme

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

Defined contribution (DC) pension scheme

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

Distribution Network Operators (DNOs)

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

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

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

Distribution Price Control Review 4 (DPCR4)

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

Distribution Price Control Review 5 (DPCR5)

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

E

Early Retirement Deficiency Contributions (ERDCs)

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

ESPS

Electricity Supply Pension Scheme.

F

Financial Reporting Standard 17 (FRS17)

The UK GAAP Financial reporting standard out the accounting treatment for retirement benefits such as pensions and medical care during retirement.

G

Gas distribution networks (GDNs)

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

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

Gas Distribution Price Control Review (GDPCR)

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

Gas Transporter (GT)

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

N

National Grid Gas (NGG)

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

National Grid Electricity Transmission (NGET)

NGET owns and maintains the high-voltage electricity transmission system in England and Wales.

Net present value (NPV) neutral

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

O

Operating expenditure (opex)

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

P

Pension Protection Fund (PPF)

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

R

Regulatory asset value (RAV)

The value ascribed by Ofgem to the capital employed in the licensee's regulated distribution or (as the case may be) transmission business (the 'regulated asset base'). The RAV is calculated by summing an estimate of the initial market value of each licensee's regulated asset base at privatisation and all subsequent allowed additions to it at historical cost, and deducting annual depreciation amounts calculated in accordance with established regulatory methods. These vary between

classes of licensee. A deduction is also made in certain cases to reflect the value realised from the disposal of assets comprised in the regulatory asset base. The RAV is indexed to RPI in order to allow for the effects of inflation on the licensee's capital stock. The revenues licensees are allowed to earn under their price controls include allowances for the regulatory depreciation and also for the return investors are estimated to require for providing the capital.

RPI-x@20

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

S

Scheme sponsor(s)

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

T

Transmission Price Control Review (TPCR4)

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

Transmission Owners

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

Weighted Average Cost of Capital (WACC)

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

Appendix 4 - Feedback Questionnaire

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

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

1.2. Please send your comments to:

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