Price Control Pension Principles Second 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, energy suppliers and any other interested parties.

Overview: Ofgem regulates the electricity and gas network monopolies to protect the interests of present and future consumers. We set a price control every five years for each group of network operators (NWOs) which sets the total revenue allowances that each NWO can collect from customers and place incentives on them to innovate and find more efficient ways to provide an appropriate level of network capacity, security, reliability and quality of service. As part of setting revenues we consider the treatment of pension costs. This consultation sets out a range of options, including maintaining our current approach to dealing with pension costs. We welcome stakeholders' view on these options. We will hold a seminar during the consultation period and consult again in October before reaching a decision on how to proceed in our Final Proposals of the Distribution Price Control Review at the end of the year.

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Context

Ofgem's principal objective is to protect the interests of current and future consumers. We regulate the network operators (NWOs) by setting a price control every five years. 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 treatment of pension costs and have applied these through three price controls - electricity distribution, transmission and gas distribution. After one full round of price controls and given recent developments in the pension environment, including the sharp rise in defined benefit pension costs and deficits, we consulted in August last year on whether we were applying these principles effectively and delivering a fair deal to customers, shareholders and employees in the companies. We also held a stakeholder workshop and commissioned the Government Actuary's Department (GAD) to analyse each of the licensees' schemes. We commenced our review last year and, following last years' consultation, all network operators were asked to submit details of their pension schemes, and we commissioned the Government Actuary's Department to review the information. We have liaised with other utility regulators and the Competition Commission to understand their approach to this issue and with The Pensions Regulator.

In this document, we set out the outcome of our review to date, and a range of policy options including maintaining our existing approach. Existing pension liabilities will be funded and are not being put at risk. We are simply trying to make sure that in future NWOs continue to manage their pension costs effectively on customers behalf. We also want to make sure that our arrangements lead to similar incentives on NWOs as other regulated and unregulated companies so that pension arrangements for energy networks track what is happening in other comparable companies.

Although this review of our approach to applying the principles covers all the price controlled energy networks, it is particularly relevant for the DNOs, as we are now undertaking a Distribution Price Control Review (DPCR5) to set the price controls for the DNOs for 2010-2015. We will set out our decisions on the treatment of treatment of pension costs in DPCR5 in the Final Proposals due to be published at the end of this year, following a further consultation in October.

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

- 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 Price Control Review Policy Paper (159/08) http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=132&refer=Networks/ElecDist/PriceCntrls/DPCR5
- Price Control Pension Principles consultation document (120/08) http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=Pension Consultation 2008 final v2.pdf&refer=Networks/ElecDist/PriceCntrls/DPCR5

- Open Letter: Price Control Pension Principles Questionnaire http://www.ofgem.gov.uk/Networks/Documents1/Pension%20questionnaire%20covering%20letter.pdf

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Summary

Our principal objective is to protect the interests of present and future consumers. For the energy network operators (NWOs), this means regulating their revenues, the charges customers pay and the quality of service. When 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. We have applied these with minor refinements through three price controls. We think it is appropriate to review how we apply the principles after one full round of price controls and given the significant changes in the pension environment, including significant increases in the costs of employer contributions for defined benefit schemes

We want to allow stakeholders to give their views on whether our current approach remains appropriate or whether it could be improved. Existing pension liabilities will continue to be funded and are not being put at risk. We are simply trying to make sure that in future NWOs continue to manage their pension costs effectively on customer's behalf. We also want to make sure that our arrangements lead to similar incentives on NWOs as other companies so that pension arrangements for energy networks track what is happening in comparable companies.

We published an initial consultation last August and held a stakeholder pensions seminar in October. We issued a questionnaire to all NWOs about their pension schemes and liabilities. We asked the Government Actuary's Department (GAD) to analyse the results of this questionnaire together with a questionnaire submitted voluntarily by Centrica. Centrica operates in competitive markets but its pension schemes have a similar origin to those of the NWOs and they suggested it provided a useful basis of comparison. We summarise the GAD report in this document and a copy of the report and NWOs' questionnaire responses are on our website. We have liaised with other UK economic regulators, who have to face similar issues when they set price controls and with the Pensions Regulator who regulates the action of the trustees of the pension schemes that the NWOs sponsor.

GAD's analysis has focussed on the costs of providing defined benefit (DB) pension schemes. These differ from the rest of the NWOs' costs because they are very uncertain. DB schemes entail an employer entering into an obligation to pay an employee a future stream of income usually based on their salary at their retirement date. The contributions that need to be paid to meet this obligation are estimates. These contributions may not be sufficient to meet the liability leading to pension deficits. This is because many of the factors that determine the eventual cost are not known such as the employees' final salary, their lifespan and the performance of the investment funds used to meet the obligation. This can pose difficulties for regulators seeking to make an assessment of their efficiency and also in the allocation of the costs of meeting liabilities fairly between current and future consumers.

The GAD review suggests that individual elements of the NWOs' DB pension schemes, including funding levels, actuarial assumptions and investment performance are not materially out of step with comparable UK company DB schemes. However, the current employer contribution rates for active members of many of the schemes are materially higher than the UK average of 15 to 16 per cent

of pay, especially in the case of the GDN schemes. Our first pension principle is that in setting price controls we will allow for economic and efficient employment costs including pension costs. In determining allowances for other elements of employment costs, we typically use benchmarking to set efficient ex ante allowances. NWOs that spend more than their allowances are exposed to a proportion of any difference. This is a generally accepted feature of price controls. But with pension costs, these comparative techniques are harder to apply fairly, as different assumptions can lead to very different estimated costs for the pension liabilities and costs that companies have (and will) incur.

In practice, our approach has typically allowed NWOs to recover their pension costs in full. It has proved very difficult to demonstrate costs are inefficient given the complexity of the schemes even when some regulated network companies' pension costs are significantly higher than comparable unregulated UK companies are.

A number of respondents raised concerns that we were seeking to direct the actions of companies and trustees to change their existing pension arrangements. They said we did not have the powers to do this and that any proposals we made would need to be consistent with the rules established by the Pension Regulator. This is not our aim. We understand that we have no regulatory remit over the action of the trustees of the pension schemes that the NWOs sponsor. We do regulate the network operators but we do not direct them to make particular decisions about the operation or management of their business. We use incentive-based regulation to try to replicate the incentives that other, non-regulated commercial companies operating in competitive markets face to manage their costs.

The issues faced by the NWOs in managing the historic liabilities and the ongoing costs of pension provision are also being addressed by other large companies in the UK. Our current approach to dealing with pension costs differs from that adopted by other utility regulators. Our analysis also suggests that our current approach may not in practice provide the same incentives on companies to manage existing pension liabilities and future pension liabilities that other large UK companies face.

We set out in this consultation a range of options for treating pension costs in future price controls. The options are based on splitting the pension costs into three elements: liabilities for past pension provision; the ongoing costs (and then any incremental deficit that subsequently arises) of defined benefit schemes; and the cost of servicing a defined contribution scheme. The options we set out involve introducing some incentives for NWOs on some (or all) of these three elements. The options propose different levels of exposure for shareholders of the NWOs to the three different elements. This reflects the different level of influence and control that NWOs have over the different elements.

Existing price controls will not be affected by any subsequent decision. Many respondents have argued we should not change our current approach. We have not ruled out this option. Nevertheless, we have identified a range of options for providing incentives on companies to manage past and future pension liabilities that we think are broadly consistent with those faced by other regulated and unregulated UK companies. If we do decide to continue with the current approach, we want to make clear that this de-risking compared to other regulated companies will be a factor in assessing the appropriate cost of capital in future price controls.

1. Background

Chapter Summary

This chapter sets out the background to the review of the application of our pension principles, including the consultation and review process to date and comparison of our approach with that of other regulators.

Question 1: Should we continue with the current approach, which puts the onus on us to review information submitted by the NWOs to make judgements of efficiency or otherwise, or should we introduce some incentives on NWOs to manage existing and future pension liabilities?

1.1. The purpose of the current consultation process is to give stakeholders an opportunity to provide views on whether the application of our pension principles remains appropriate or whether it could be improved.

1.2. This document is our second consultation on the application of our pension principles and within that framework it sets out options for incentivising network operators (NWOs) to efficiently manage their pension costs. It follows on from the August 2008 consultation and October 2008 workshop. We have considered carefully responses to the document and the views expressed at the seminar.

1.3. In this document, we set out the outcome of our review to date, and a range of policy options including maintaining our existing approach. Although this review of our approach to applying the principles covers all the price controlled energy networks, it is particularly relevant for the DNOs, as we are now undertaking a Distribution Price Control Review (DPCR5) to set the price controls for the DNOs for 2010-2015. We will set out our conclusions to how we intend to treat pension costs in DPCR5 in the Final Proposals due to be published in November this year.

Background

1.4. 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. We have applied these with minor refinements through three price controls

- electricity distribution (DPCR4), transmission (TPCR4) and gas distribution (GDPCR)[1].

1.5. Pensions are important because their costs represent a significant proportion of NWOs' total costs. Moreover, they are rising significantly. We have a primary statutory duty to protect current and future consumers. We also have a duty to ensure that efficient and economic NWOs are financeable.

1.6. The DB schemes were originally the pension schemes of the nationalised gas and electricity industries prior to privatisation. At privatisation employees' pension arrangements in the electricity sector were guaranteed by legislation[2] and the benefits are protected. In the gas sector, the scheme rules set a similar hurdle in terms of requiring members' agreement to changes in the levels of employee contributions or benefits. Most of the schemes are now largely closed to new employees. As far as we are aware, the only other UK industry that has a similar arrangement is the rail sector[3].

1.7. The aggregate DB current funding allowance[4] set for the monopoly networks is £441 million per year (in DPCR4, TPCR4 and GDPCR). However, the regulatory treatment provides that we allow the companies to recover their actual pension costs, provided 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 5 per cent and DNOs have forecast further significant cost increases both for ongoing pension costs and in particular for deficit recovery. We expect to see a similar trend of pension costs exceeding the price control allowances that have been set for the transmission and gas distribution companies following their next triennial valuations.

1.8. Since 2003, there have been significant developments in the UK pension environment, including the Pensions Act 2004, which led to the introduction of The Pensions Regulator (TPR) and the Pension Protection Fund (PPF). There have been

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[1] Distribution Price Control Review 4 – Final Proposals (265/04)
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=51&refer=Networks/ElecDist/PriceCntrls/DPCR4
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

[2] The Protected Persons Schedule of the 1989 Electricity Act protects the benefits of all relevant scheme members at the time of privatisation.

[3] Railways Act 1993, Schedule 11 and The Railway Pensions (Protection and Designation of Schemes)
Order 1994.

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

changes in mortality, investment yield assumptions, lower interest rates and the introduction of scheme specific funding. Since we set the principles, there has been a sharp rise in employer contribution rates and deficit repair payments driven by the recent turmoil in financial markets.

1.9. In electricity distribution, we have seen deficits more than double since the previous valuations on which the DPCR4 allowances were based. In their forecasts for DPCR5, DNOs have provided updated actuarial evidence that the schemes' deficits have increased from the last triennial valuations by over 260 per cent to over £3.3 billion[5].

1.10. In the wider UK private sector, since the credit crunch started and in the ongoing difficult economic climate many companies have sought to reduce substantially their pension costs and, in particular, the cost of funding increasing deficits. Many large schemes have now closed and in many others, contribution rates have been increased and/or benefits reduced.

1.11. Given these changes in the UK pension environment, we think it is appropriate to review the working of the 2003 principles and consult further on the way in which we apply them. The question is whether we should continue with the current approach, which puts the onus on us to review information submitted by the NWOs to make judgements of efficiency or otherwise, or should we introduce some incentives on NWOs to manage existing and future pension liabilities?

1.12. We are concerned that our existing approach may not provide the same incentives on NWOs that are faced by other regulated and unregulated private sector companies to manage pension costs. Since the first consultation, there has been an increasing trend by private sector employers to close their DB schemes. In others, they have amended the rules of defined benefit schemes for example by basing pension rights on career average earnings rather than final salaries, or reducing the accrual rate for years of service from 1/60th per year to 1/80th per year. Others have sought higher contributions from employees.

1.13. We recognise that there may be greater constraints on NWOs seeking changes in benefits, due to the legislative protection given to members of the electricity schemes at privatisation and the scheme rules that apply to the gas schemes. In any case, changes to benefits are only one way of managing the costs of pension schemes (or of employment costs more generally) and we do not seek to encourage particular actions by NWOs, only to ensure that they manage the costs of existing and future liabilities. We do recognise that for some of the schemes these incentives are likely to be in place as some of the schemes of which NWOs are sponsors also include members who work in other sectors of the industry that are now competitive markets.

5 This figure is before adjusting for the regulatory fraction.

Our role in the pensions framework

1.14. There are a number of key actors who may have influence on the decisions taken by pension schemes and sponsoring employers.

1.15. ***The trustees*** are responsible for running the pension scheme within the terms laid down by the scheme rules. The trustees are normally responsible for agreeing the funding of the schemes, with the sponsoring employer. Although they are required to act independently when carrying out their duties as trustees, many work for the sponsoring employer. Their decision-making is bound by legislation, and the schemes are regulated by the Pensions Regulator. Some decisions regarding the scheme may require the agreement of a certain proportion of the members, for example changes to benefits.

1.16. ***The Network Owner (NWO)*** is the sponsoring employer. It negotiates wage and other employment terms with its employees. The terms of pension schemes, i.e. the trust deed and rules are initially determined by the employer but changes to these may need the consent from a combination of trustees, employers and members. As the sponsoring employer the NWO is responsible for paying off deficits if past contributions by both the employer and employee are estimated to have been inadequate. The deficit recovery plan must be agreed with the trustees, which should take into account the networks' ability to afford the payment profile.

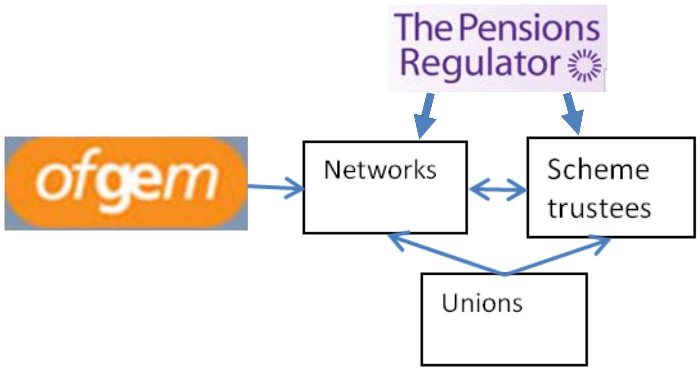
1.17. ***Ofgem*** regulates the network owner, and uses the price control mechanism to incentivise it to take efficient business decisions. Our decisions about how much to allow for deficit funding in a price control settlement determines the risk that shareholders face relating to current and future pension liabilities. We do not have, nor do we seek, any control over the trustees or to direct what the companies must do or the pension arrangements they choose to put in place.

1.18. ***The employees*** are the members of the scheme. They negotiate (often through trade union representatives) their employment terms and conditions with the network. They make contributions to their pension funds, although in the case of DB schemes, these contributions have largely been fixed as a percentage of salary (in some cases due to legislation at the time of privatisation) as their employers' contributions have been rising sharply.

1.19. ***The Pensions Regulator*** was set up in 2005 and its statutory duties require it to protect benefits of members of work-based pension schemes and to reduce the risk of claims on the Pension Protection Fund. It requires deficits to be paid off as quickly as possible, subject to affordability. TPR has influence over both the sponsoring employer and the trustees, e.g. if the trustees and employer cannot agree on the funding, TPR steps in to set the contributions.

1.20. The influences each actor can bring to bear are shown diagrammatically below:

Diagram 1.1 The pensions framework



Existing pension policies

1.21. Our approach to the treatment of pensions within price controls is to have a core set of principles for all distribution and transmission licensees to be consistently applied subject to the different contexts of each price control review. These principles were first developed in our *Developing Network Monopoly Price Controls May 2003*[6] *document* to which reference may be made.

1.22. The principles are set out in more detail in Appendix 3, but briefly, are as follows:

- Principle 1 - Licensees can recover economic and efficient salary and pension costs,
- Principle 2 - Licensees can recover the attributable regulated fraction only,
- Principle 3 - Ex-ante adjustments to allowances may be made where there has been a failure in stewardship,
- Principle 4 - Pension costs will be assessed using actuarial valuations,
- Principle 5 - Adjustments will be made to allowances for under funding / over funding, and
- Principle 6 - The additional cost of unfunded Early Retirement Deficiency Contributions will be borne by the licensee.

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

1.23. They formed the basis of the approach to pensions in DPCR4 and with some evolution, in the TPCR4 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. Thus, exceptions or amendments to the principles have been and will be made, where appropriate.

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

- How the pension schemes of sponsor companies compare in practice with those offered by companies operating in competitive markets;
- If the pension scheme is estimated to be in deficit (surplus), how this has arisen or is expected to arise, and what is an appropriate period over which it is to be recovered;
- The impact that funding a pension scheme deficit may have on the financial position of a company, and;
- External forces and controls that affect the scheme including the Pensions Act 2004, TPR and PPF interaction.

1.25. In applying the principles in practice in DPCR4, TPCR4 and GDPCR, we have effectively allowed the NWOs an ex ante allowance equal to their estimate of pension costs applicable to the regulated business (we have adjusted this proportion where appropriate, and deducted unfunded ERDCs). Because of the difficulties of making the assessments noted above, we have also allowed an ex post adjustment that is close to a pass through of the costs incurred.

1.26. We think that in practice, this approach significantly reduces the risks the network companies face relative to unregulated companies and in other regulated sectors. Since the principles were introduced in 2003, DPCR5 is the first time that we have had to compute the ex post adjustments and deal with any application issues.

Consultation and review process to date

1.27. Most network companies have indicated in their responses to the first consultation document that they believe the current principles are working well, although other respondents queried whether we could do more to ensure that consumers do not bear inefficiently incurred pension costs.

1.28. We held a seminar in October 2008 in response to some concerns expressed by stakeholders about the tone of the August document. The seminar was to review the operation of the Price Control Pension Principles first set out in 2003. It was well attended by representatives of all major stakeholder groups. At the seminar, we clarified that the August 2008 pensions consultation document was not intended to express any particular views or changes we may wish to consult on, but simply to initiate the debate. The context of that debate was that, given the magnitude of pension costs (around 8 per cent of allowed revenues and increasing) and the increasing volatility of deficit estimates, we need to ensure that the pension principles, especially Principle 1[7] ('Efficient and Economic Employment and Pension Costs') are working well and that companies have undertaken all possible steps to ensure that their customers are only paying for efficiently incurred costs.

1.29. During the seminar of 8 October 2008, the GMB, Energy Networks Association, Centrica plc and Ofgem made presentations - these are available on our website[8]. These were followed by a question and answer session, which allowed attendees including unions, network operators, pension trustees and actuaries to question the ideas in the document and to express their views on the direction of the consultation process.

1.30. One consensus that emerged from this debate was for greater transparency by employers and trustees in publicising both their actuarial assumptions and data to inform debate, thereby enabling an assessment of pension costs and the working of Principle 1.

1.31. In the seminar, it was also agreed that there is need for greater transparency of the key assumptions used to determine pension costs and the actions network companies have undertaken to manage them.

1.32. In December 2008 we issued a questionnaire to licensees about their DB pension schemes and the Government Actuary's Department (GAD) has reviewed the responses. We issued the questionnaire to provide the opportunity for companies to make available information to improve transparency and to demonstrate that they are meeting the first pension principle. It has enabled us to collect data on the relevant defined benefit pension schemes and any actions taken by the companies to manage their pension costs and to assess the costs and evaluate those actions taken under each scheme in meeting that principle.

Publication of the GAD report and the licensees' questionnaire responses

1.33. All licensees gave consent to publication of the GAD report.

[7] Principle 1: "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"
8 www.ofgem.gov.uk/networks

1.34. We considered that licensees' questionnaire data should also be published because it would promote the interests of consumers. Pension costs currently comprise 7 per cent and 8 per cent of the total electricity and gas network costs and are likely to rise in future. Additionally, a broad range of stakeholders attended our pension seminar in October 2008, including licensees, unions (representing employees/ scheme members), actuaries, trustees and consultants and there was a strong consensus that there was a need for transparency of actions in relation to different schemes and their pension data. We believe publication of the questionnaire data would promote the interests of consumers over and above the value of publishing the GAD report alone.

1.35. A number of licensees consented to publication of their questionnaire data only on the basis that the data for all network operators was published. All the questionnaire data is published on our website except for a small amount of information which we accept should remain confidential.

1.36. However, the information contained in the GAD report and in the questionnaires focuses only on particular elements of network operators' defined benefit occupational pension schemes for the purposes of our review of how Ofgem's first and third pension principles are being applied. The information does not present a complete picture in relation to any scheme individually or the networks' pension schemes as a whole.

1.37. Neither the licensees nor Ofgem accept any liability in respect of any errors or omissions or for any loss or damage arising from use of the information in the GAD report and the questionnaire responses.

1.38. The GAD report is available on our website together with the completed questionnaires. For a summary of that review and our own review of investment strategies see chapter 2 of this document.

Comparison with other regulators

1.39. We have reviewed the approaches other economic regulators have taken in assessing and allowing pension costs in setting their price controls. Except for the railways, no other general utility sector has protected pension legislation. The railway scheme is still open to new members. Postcomm, following a review developed a sharing mechanism to spread ongoing contributions between customers and shareholders. A two-tiered approach is used by Ofwat, funding companies' pension requirements where they have demonstrated a prudent and open approach whilst only part funding those that have put forward their requirements late in the process. In the telecoms sector, it is understood that Ofcom may not allow Openreach to recover any of its pension deficit through its price control, but has recognised that the long-term approach to this needs further thought. ORR sets an ex ante allowance based on benchmarking operating costs with no ex post adjustment. The Competition Commission in its recent review of airports has put a cap on ex ante allowances and reduced the amount in RAV to reflect the effect of previous contributions holidays. Further details may be found on each of their websites.

1.40. However, we recognise that comparisons can be misleading. Other industries may have different histories, and the regulator's duties and responsibilities may be different, too. For example, not all regulators have an equivalent of our duty to secure that licensees are able to finance themselves. In some industries, there is not even a licensee, and the regulator's duty is to ensure that consumer demands are met by the industry, collectively. Prior to DPCR4, we did not look at pension costs and their funding in isolation, viewing them as just one component of overall employment costs. At DPCR4 and subsequently, we have set explicit pension allowances. In the context of energy networks, significant surpluses were recorded in NWO pension schemes in the last quarter of the 20th century, enabling them to reduce the level of annual contributions to the pension schemes, which NWOs argue were effectively passed on and shared with consumers through lower costs.

1.41. We have therefore come to an initial view that we appear to expose network companies to less risk than broadly comparable regulated companies under the current application of the pension principles do. All other economic regulators, including the Competition Commission have a policy framework that leaves shareholders of the regulated company with at least some, and in certain cases, all of the risk attached to deficit funding. Whilst our principles mean that under certain circumstances (unfunded ERDCs, significant pension costs attached to the non-price controlled element of the business) NWOs may be exposed to some risk, this is a contingent outcome, which many licensees may be able to avoid.

The regulatory regime for pension schemes

1.42. We have examined the regulatory regime for pension schemes in order to understand how it may influence and inform our own proposals. The remit of each regulator (i.e. Ofgem and TPR) is different, although both have the protection of individuals as their aim. Ofgem's remit is to protect current and future generations of energy consumers and through price controls sets the total revenues that each licensee can collect from customers at a level that allows an efficient business to finance their activities. TPR's remit is to protect benefits of members of work-based pension schemes, through the regulation of both defined benefit and defined contribution schemes. The funding of DB schemes has two aspects: setting the funding target and assessing the funding position of the scheme (the valuation); and setting a recovery plan where there is any deficit.

1.43. The Pensions Act 2004 requires funding levels to be scheme specific and prudent. TPR's scheme funding regime is flexible, allowing scheme security to be delivered in a number of ways. They allow significant flexibility on asset allocation and funding assumptions, requiring only that the overall approach is prudent, and reflects the strength of the employer covenant in order to ensure responsibility for outcomes rests with the scheme and the employer). We understand that TPR's view is that for companies with a strong employer covenant, (that is, a business that is expected to be around for a long time), trustees need not expect funding to be at the full level of a buyout (and, in practice, that rarely occurs). TPR also considers that, where there is a stronger employer, the trustees would be able to allow for higher investment performance. Regulated energy companies might be expected to fall into this category, at least in relation to the regulated portion of their business. For a strong employer the current legislative framework does not appear to force trustees to require fast funding, which therefore could be over a relatively long period. TPR has not explicitly stated their view of what long is. They have stated that anything longer than ten years would trigger their interest and further enquiry, but information published by TPR also shows that, in a very small number of cases, recovery plans in excess of 20 years have been approved.

1.44. Trustees have obligations to ensure that the scheme is fully funded against the target set. When a deficit arises, trustees must aim for the deficit to be repaired in as short a period as a sponsor can reasonably afford[9]. A stronger sponsor would be expected to pay off a deficit faster than a weaker one. Sponsoring regulated energy companies rely on Ofgem setting their revenues before they can assess the affordability of a recovery plan. However, an expected recovery plan is part of our assessment of required revenues. Affordability of pension deficits is therefore an issue in both regulatory regimes.

1.45. Where employers propose longer deficit recovery periods because of affordability issues, TPR may question the employer's use of free cash, such as the level of dividend payments (as their remit does not allow longer funding periods other than for employer affordability). In TPR’s view, longer recovery plans increase the risk to members' benefits. TPR may, however, be willing to consider the setting of longer recovery plans where they are backed up with guarantees through the use of contingent assets and similar mechanisms. As noted above, TPR has not explicitly stated their view of appropriate recovery plan length. The over-riding principle is for deficits to be repaired as quickly as is reasonably affordable.

1.46. If genuine affordability issues develop and a recovery plan needs to be revised TPR expect the adverse impact of economic conditions to be shared by the stakeholders, other creditors and the regulated company.

1.47. The imposition of a new price control during the course of a recovery plan period should not, of itself, require a reopening of the valuation and a change in the funding target. In between valuations of the pension scheme, only changes, whether to prices or to any other factor, which had a significant impact on the strength of the employer, should require a reopening of an agreed valuation.

1.48. So far as pensions regulation is concerned, the risk of repairing deficits resides with the employer, and ultimately the shareholder. A pension scheme in deficit ranks as an unsecured creditor of the employer in insolvency. If funding periods are re-opened and extended to assist an employer in difficulty, TPR would expect wider financial arrangements - including any dividend policy to be reviewed as well. TPR

[9] see paragraph 101 of TPR Code 3, http://www.thepensionsregulator.gov.uk/pdf/codeFundingFinal.pdf

has powers to take action if it considers that inadequate payments are being made to the pension scheme.

1.49. In reviewing deficit funding, both pensions and energy regulatory frameworks must, as a matter of law, apply. Trustees, sponsors and Ofgem must, therefore, work within both frameworks in deciding what is appropriate for setting deficit funding and which parties should carry the risks.

Next steps

Pension treatment at DPCR5 Initial Proposals

1.50. For DPCR5 Initial Proposals we are using broadly the status quo as our modelling assumption for determining allowed revenues. This is set out in more detail in Chapter 5 to Initial Proposals Technical Document 4. We have modelled pension costs using DNOs' own estimates subject to applying our marker view of the appropriate regulatory fraction. We have not made a decision on this matter and so this choice should not be treated as our minded to position, which we will clarify in October, and which will be informed by responses to this pension consultation.

Further consultation

1.51. As discussed in chapter 4, we do not have a minded to view on what we intend to do at this stage but are consulting on a range of options including maintaining our existing approach. Some of these may be considered as more appropriately dealt with at future projects - TPCR5, GDPCR2, or within the scope of the RPI-X@20 review. TPCR5 is the next review of the transmission operators and due to start in the next year. The RPI-X@20 review is currently under way and due to report in the summer of 2010[10].

1.52. This paper is open for consultation for 6 weeks. It is our intention to publish an update on our views, having considered the responses and undertaken further analysis of the latest DPCR5 data submissions, together with the responses in October 2009. In that update we will clarify our minded to position for DPCR5 which may be subject to further review. We will hold a further seminar during the consultation period before reaching a decision on how to proceed in our Final Proposals for the Distribution Price Control Review at the end of this year.

[10] RPI-X@20 review:
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=1&refer=Networks/rpix20/publications/CD

2. GAD report and our review of investment strategies

Chapter Summary

This chapter summarises the GAD review of the data obtained through the pension questionnaire, it looks at what has been done and what more might be done to reduce pension costs by companies, compares NWOs' investment strategies and actuarial funding valuations. We also summarise our own review of investment strategies and returns. This concludes that on balance, whilst generally under-performing, there is no evidence of a failure of stewardship.

Background and purpose of the reviews

2.1. In December 2008, we issued a questionnaire to all NWOs with the intention of improving transparency and providing the companies with an opportunity to demonstrate that they are meeting the first and third pension principles (see paragraph 1.22 above). We were following the consensus view expressed at our Pension seminar. The questionnaire has enabled us to collect data on the relevant defined benefit pension schemes and any actions taken by the sponsoring employers to manage their pension costs. It also gives us information to help us assess the costs of servicing the schemes and to evaluate the actions taken. We appointed GAD to review the results, which are summarised below. The report is available on the same part of our website as this consultation.

2.2. In addition to the questionnaires and the GAD report, we have undertaken a review of the efficiency of schemes' investment returns and strategy. Our objective was to review compliance with the second pension principle. The focus of that review was primarily on DNOs' DB pension schemes and the application of that principle to DPCR5 and assess whether the DNOs' pension schemes' investment returns and strategy appear efficient compared with schemes in the wider UK private sector. We included GDNs and TOs' schemes to provide a larger sample for analysis. Sometimes one scheme will cover more than one DNO, or one DNO may have more than one scheme.

2.3. The nature of a detailed review of individual schemes makes it very difficult to make robust judgements regarding efficiency. This is because there may be valid reasons for differences between schemes, and for different decisions that affect the cost of maintaining the scheme. We are not sure that that placing the onus on Ofgem to prove inefficiency, rather than for NWOs to prove efficiency, is the best approach for consumers. With other types of costs, we use tools such as benchmarking to arrive at reasonable ex ante assessments of the amounts required, and still allow NWOs to make the case as to why they may be efficient even if they are underperforming the benchmark.

2.4. In reviewing the detail of different schemes, we do not want to create the impression that we are seeking to direct trustees or NWOs to make different decisions regarding the pension arrangements for the NWO's employees. We do not seek to manage or direct NWOs' decisions in this way. We prefer, wherever possible, to use incentive-based regulation to create similar pressures to those experienced by firms in competitive markets, under which they will negotiate fair remuneration packages with their employees, taking full account of the costs of the commitments entailed in these packages as well as the benefits to their business of attractive employment terms and conditions.

2.5. For these reasons, the options set out in the next chapter are focused on ways of bringing incentive-based regulation to bear on this element of NWOs' cost base.

GAD Report on the pension questionnaires

2.6. The review considered licensees' DB schemes in isolation and no other elements of the employees' overall remuneration packages. Simple comparisons across schemes do not take into account all relevant circumstances of each scheme and sponsors. We may carry out further work to benchmark total employment costs. GAD's analysis enables us to understand the main differences between NWOs' cash contribution rates and the extent of actions they have taken to reduce their pension costs, in order to inform and assess compliance with our pension principles.

2.7. Their review looked at a number of issues that impact the estimated costs of funding a DB scheme. These include:

- Are the DB schemes open to new members, and if not when did the scheme close?
- What benefits are provided, and has the level of benefits changed since privatisation. If so why, and how, has this affected the cost of servicing the schemes?
- What contribution levels do employees make?
- How do actuarial assumptions on life expectancy of the members, salary growth, future investment performance, etc. affect the estimate of the funding level?
- What is the investment strategy?

2.8. All licensees were covered by the review, as follows:

CN West	Central Networks West plc
CN East	Central Networks East plc
ENW	Electricity North West Limited
CE NEDL	Northern Electric Distribution Limited
CE YEDL	Yorkshire Electricity Distribution plc
WPD S Wales	Western Power Distribution (South Wales) plc
WPD S West	Western Power Distribution (South West) plc
EDFE LPN	EDF Energy Networks (SPN) plc
EDFE SPN	EDF Energy Networks (LPN) plc
EDFE EPN	EDF Energy Networks (EPN) plc
SPD	SP Distribution Limited
SPM	SP Manweb plc
SSE Hydro	Scottish Hydro Electric Power Distribution plc

SSE Southern	Southern Electric Power Distribution plc
NGG	National Grid Gas plc
NGN	Northern Gas Networks Limited
SGN	Scotia Gas Networks
WWU	Wales & West Utilities Limited
NGET	National Grid Electricity Transmission
SHETL	Scottish Hydro-Electric Transmission Limited
SPT	SP Transmission Limited

2.9. There are a number of ways we might assess the efficiency of the NWOs pension costs, these include the use of benchmarking - contribution rates, total employment costs, investment strategies and returns - against energy and other regulated utilities and the wider UK private sector. In addition, we may review and compare actions taken to mitigate pension costs and whether they have, or could apply similar methods. However, they are challenges and difficulties in applying benchmarking and other efficiency assessment methodologies as each sector and scheme has unique features. Despite a common foundation from the British Gas and ESPS schemes, they have all developed differently applying their own business philosophy, and thus have somewhat divergent past historic experiences influencing their position today. These include changes in ownership, how schemes utilised past surpluses, different longevity assumptions and a tendency to adopt policies that lead to a larger deficit valuation. It is very difficult to evaluate the extent to which these actions are justified by the specific circumstances of each scheme. Other issues include when they closed to new members and for the electricity schemes the protection afforded member by the Protected Person's legislation.

2.10. A high-level summary of their review follows.

What has been done to reduce costs?

2.11. All DB schemes, apart from Western Power Distributions' DNOs (WPD), are effectively closed to new entrants, who instead have the opportunity to join a defined contribution scheme. The switch to DC pension schemes removes any NWOs' exposure to the risk of insufficient funding for members of these schemes. WPD argue their costs are efficient and they are in the upper quartile on our cost assessment benchmarking, inferring that the productivity of employees and their businesses is high. Their current deficits appear broadly in line with their peers given their size.

2.12. Some NWOs (ENW, CE NEDL, CE YEDL, SPD and SPM) have recently introduced or intend to introduce salary sacrifice schemes[11], although the savings from doing so are small and arise principally from savings in national insurance contributions.

What more could be done to reduce costs?

2.13. Restrictions put in place at privatisation on electricity businesses and in the gas scheme rules require that two thirds of members must agree before a change of scheme benefits can be made. Whilst this is a challenging hurdle to overcome, it is one that other schemes in the energy sector have satisfied, although the reasons for their success are outside the scope of the review. Some schemes still have lower employee contribution rates than at privatisation, although this has a marginal effect on required employer contributions. It is possible that active members who are not covered by the protected person's legislation could be asked to make higher contributions than those set at privatisation.

Comparison to other schemes

2.14. NWOs schemes offer slightly more generous benefits than typical UK private sector DB pension schemes for example a lower retirement age, no cap on indexation of salaries or pension increases (although employers reserve the right to review the position if these exceed 5 per cent above inflation), a higher proportion of pension for dependents. Electricity pension schemes are based on providing 1/80th of final salary for each year of service compared to gas (and many typical UK) schemes where benefits are accrued on 1/60ths of final salary, but the electricity schemes also include a lump sum at retirement of 3/80ths of final salary. Some electricity schemes also offer 1/60ths.

2.15. This reflects benefit improvements made in the 1990s and early 2000s, which in accordance with the scheme rules, used valuation surpluses for this purpose. Should the schemes ever go into surplus in the future it is likely that trustees may seek to de-risk their investments strategies. It is extremely unlikely that surpluses would or could under current legislation be shared with sponsors. As a result consumers would not under our over/under funding principles benefit at the next price review, unless we set allowances that took account of the surplus even though the sponsor was not able to reduce its contributions.

2.16. Actuarial assumptions on average are broadly consistent with typical UK schemes, but it is observed that real salary growth is assumed to be 1.5 to 2 per cent per annum by many schemes, which is not necessarily consistent with price

[11] A salary sacrifice arrangement in respect of pension scheme benefits is where the member's salary is reduced by the amount of the member pension contributions that the member would normally pay, and instead the employer meets the cost of the member pension contributions.

control assumptions, although we recognise that the actuarial assumptions apply over a much longer time frame (essentially until each employee retires) than the five years of a price control review.

2.17. Actuarial assumptions can have a significant impact on pension liability valuations. It is not always straightforward to understand the basis for differences between the scheme specific assumptions made by each scheme.

Higher average SCRs ("Standard Contribution Rates")

2.18. Most of the electricity schemes have SCRs between 20 per cent and 24 per cent compared to typical UK private sector scheme SCRs of around 15 to 16 per cent. The difference is partly due to higher benefits and changes in valuation methods that are not yet reflected in the typical statistics for the private sector. However, once the effect of the new scheme specific funding regime have been fully allowed for it is possible that the typical UK private sector DB schemes will increase to nearer the electricity schemes SCRs as the published data is out of date.

2.19. The Scots pension schemes have higher contribution rates (29 to 33 per cent) than other schemes, partly due to higher accrual rates, actuarial assumptions and in the case of SP Pension Scheme, a lower rate of member contributions. ENW has a contribution rate of 30 per cent, although comparisons are difficult due to a different valuation date.

2.20. Gas schemes have significantly higher contribution rates, (31 to 39 per cent). By comparison, Centrica's schemes, which originated from the same industry, have rates of 22 to 23 per cent.

2.21. Funding levels for NWO schemes are similar to the average for UK private sector DB schemes.

Investment strategy and actuarial funding valuations

2.22. This needs to be assessed in the context of scheme maturity. Most schemes have 35 to 65 per cent of their investments in low risk assets which protect the capital and gain a modest return and the remainder (also 35 to 65 per cent) in return seeking assets (RSAs), i.e. assets which may be exposed to greater risk, but where the potential return is higher. The outliers include SGN and WWU, which have more RSAs, but their schemes are relatively immature, while Central Networks has a lower percentage in RSAs and a more mature scheme. This contrasts with WPD, which has a high percentage of RSAs, but is both a mature scheme and still open to new members.

2.23. GAD states that the difference between a scheme's ongoing funding level and its buy-out level can be taken as a broad indication of the degree of prudence adopted for funding purposes (the smaller the difference, the greater the prudence). Licensees' schemes ongoing funding levels are closer to their buy-out levels than is the case on average for UK schemes. This could imply that licensees' schemes are generally being more prudent in their choice of funding valuation assumptions than other schemes. However, other factors also need to be taken into account. The scheme's ongoing funding level would therefore be lower and closer to the buy-out level, than if less prudent funding valuation assumptions had been adopted. SPD has the highest ongoing funding level but one of the lowest buy-out levels. This suggests that SPD's strong ongoing funding level might be a function of the assumptions adopted for the ongoing funding assessment relative to other schemes. Scottish Hydro has a higher than average funding level and NG and Southern Electric have lower than average funding levels. These differences might be explained by various factors affecting their past experience on their assets and liabilities.

2.24. It is increasingly common for discount rates to be set by reference to gilt yields plus an allowance for assumed outperformance of return-seeking assets relative to gilts. Most NWOs' schemes' assumptions are broadly consistent with data gathered by TPR, which suggests typical asset outperformance assumptions are around 1.75 per cent a year pre-retirement and slightly over 0.25 per cent a year post-retirement.

2.25. Data from the Pensions Regulator suggests a typical assumption of life expectancy of 28.1 years from age 60. The majority of NWOs' schemes' assumptions are consistent with this. The Scottish Power Pension Scheme (covering SPD and SPT) has a lower than average assumed longevity (25 years) which may explain its higher than average ongoing funding level and it's higher than average difference between ongoing funding level and its buy-out level. This could reflect differences between SP's past longevity experience and that for other schemes. EDF Energy, National Grid and Scottish & Southern assume slightly higher longevity than other schemes.

2.26. Across a range of points of comparison, licensees' DB schemes are broadly in line with those of other private sector companies. However, in some cases, there is a tendency to adopt policies that lead to a larger deficit valuation, but it is very difficult to evaluate the extent to which this is justified by the specific circumstances of each scheme. Overall, their schemes require a noticeably higher contribution rate than the UK average with the gas licensees being the biggest outliers.

Implications of NWOs retaining their schemes for new members

2.27. Most schemes are closed to new members with minor exceptions; however, the WPD scheme remains open. WPD argue that their costs are efficient and that this is demonstrated by the fact that their DNOs are in the upper quartile on our cost assessment, inferring that the productivity of employees and their businesses is high. We do not have a view on whether closing a scheme is the most appropriate way to mitigate pension costs. WPD is an example of why it is inappropriate for us to direct and influence sponsors and trustees to any particular strategy; and that an assessment of whether costs are economic and efficient must consider many inter-related factors not just following a checklist of actions taken by other businesses.

2.28. However, although at DPCR5, WPD's pension costs do not look out of line with those of the other 12 DNOs, this may change in future price controls if it becomes clear that the costs (liabilities) of meeting pension commitments made in the next five years turn out to be much higher than WPD forecast. We question whether it would be appropriate for WPD to continue to benefit from its approach by scoring well on our cost activity benchmarking on the one hand, but having its DB scheme pension costs effectively guaranteed on the other hand. We would welcome views on whether a better way to assess whether it remains efficient would be to benchmark it against the other DNOs including its actual pension scheme costs. This option is explored further in chapter 3.

Review of investment strategies and returns

2.29. In addition to the work undertaken by GAD, we looked at schemes' investment strategies and investment returns over time.

Scope of review

2.30. In undertaking our review we performed the following:

- Analysed returns by year since 2000, with data taken from the pension questionnaires,
- Ranked NWOs to see if any NWO is consistently over- / under- performing others. Compared these to Centrica and other private sector schemes,
- Compared NWOs' investment returns with typical returns taken from Hewitt's pension guide[12],
- Analysed whether NWOs have significantly different investment profiles from the average UK private sector DB pension scheme and whether this gives rise to material differences in returns, and
- Considered the influence of fund investment managers on scheme returns.

Objective

2.31. The objective was to assess whether any scheme is not meeting the 'efficiency' principle and/or not demonstrating suitable stewardship over its pension fund and specifically over its investment strategy and scheme returns. Our purpose here is to ensure that consumers are not funding the any excess costs arising from a material

[12] Hewitt Pension pocket book 2009 edition published by Economic and Financial Publishing Ltd in association with Hewitt

failure in the responsibility for taking care of pension scheme resources. We have no remit over trustees' actions. We would expect licensees to challenge trustees in relation to any perceived inefficiency.

Results

2.32. As shown in the table below, by year, returns for the NWOs fluctuate significantly. No one NWO stands out as significantly under- or over- performing across all years. The table below summarises how each NWO is ranked against the others in a given year, with "1" indicating the highest ranked NWO. The rankings are also colour coded, with green indicating high ranking NWOs, yellow the next highest ranked, followed by amber then red for the lowest ranked NWOs. Comparing the NWO scheme rankings over time, SSE Southern has, on average, the highest rankings. EDF Energy has the most incidents of a low ranking (16 or 17); however, in years where the stock market has seen growth its ranking has increased (to first in one year). This could imply that EDF Energy has a higher proportion of its investments in equities. This was true until 2004; however, data gathered in our pension questionnaire and analysed by the GAD shows that this is no longer the case and that EDF Energy now has only 50 per cent of its investments in more risky return seeking-assets, which is average for NWOs. This could suggest it took action to improve its performance.

Table 1: Investment returns rankings over time

Network Operator	Scheme name	2000	2001	2002	2003	2004	2005	2006	2007	2008	Average
CN	Midlands ESPS	--	--	--	--	16	13	--	--	--	14.5
	Eastern ESPS	--	--	--	14	9	6	--	--	--	9.7
	Powergen ESPS	5	12	9	11	15	2	--	--	--	9.0
	EME ESPS	3	14	3	4	14	4	--	--	--	7.0
	E.ON ESPS	--	--	--	--	--	--	11	13	1	8.3
ENW	ENW ESPS	--	--	--	--	--	--	--	--	9	9.0
	UU ESPS	--	4	12	3	13	7	6	14	--	8.4
CE	Northern Electric Group	10	2	1	5	12	14	7	6	7	7.1
WPD	WPD S West	6	8	6	8	3	9	3	1	11	6.1
	WPD S Wales	13	3	8	8	3	9	3	1	11	6.6
EDF	London Electricity	11	9	13	6	5	5	--	--	--	8.2
	EDF	1	15	13	16	1	17	10	5	13	10.1
	EDF EFES	9	5	7	2	11	12	13	15	6	8.9
SP	SP Dist	4	13	5	11	6	7	5	9	3	7.0
	Manweb	7	10	11	7	8	14	9	10	5	9.0
SSE	SSE Hydro	7	1	2	10	6	2	2	7	2	4.3
	SSE Southern	12	7	4	13	10	16	7	12	8	9.9
GDNs	NGN	--	--	--	--	--	--	14	11	--	12.5
	SGN	--	--	--	--	--	--	--	--	10	10.0
	WWU	--	--	--	--	--	--	--	3	13	8.0
NG	National Grid	14	5	15	1	17	11	12	8	4	9.7

Table 2: Comparison with Hewitt's UK plc averages

DNOs	Scheme name	2000	2001	2002	2003	2004	2005	2006	2007	2008
CN	Midlands ESPS	N/A	N/A	N/A	N/A	90%	90%	N/A	N/A	N/A
	Eastern ESPS	N/A	N/A	N/A	90%	75%	75%	N/A	N/A	N/A
	Powergen ESPS	50%	75%	75%	50%	90%	50%	N/A	N/A	N/A
	EME ESPS	50%	90%	50%	50%	90%	50%	N/A	N/A	N/A
	E.ON ESPS	N/A	N/A	N/A	N/A	N/A	N/A	90%	90%	10%
ENW	ENW ESPS	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	75%
	UU ESPS	N/A	50%	90%	25%	90%	75%	75%	90%	N/A
CE	Northern Electric Group	75%	25%	10%	50%	75%	90%	75%	25%	75%
WPD	WPD S West	75%	50%	75%	50%	50%	75%	50%	10%	90%
	WPD S Wales	90%	50%	75%	50%	50%	75%	50%	10%	90%
EDF	London Electricity	75%	75%	90%	50%	50%	75%	N/A	N/A	N/A
	EDF	25%	90%	90%	90%	10%	90%	90%	25%	90%
	EDF EFES	75%	50%	75%	25%	75%	90%	90%	90%	50%
SP	SP Dist	50%	75%	75%	50%	75%	75%	75%	75%	25%
	Manweb	75%	75%	75%	50%	75%	90%	75%	75%	50%
SSE	SSE Hydro	75%	10%	25%	50%	75%	50%	25%	75%	25%
	SSE Southern	90%	50%	50%	75%	75%	90%	75%	75%	75%
	NGN	N/A	N/A	N/A	N/A	N/A	N/A	90%	75%	N/A
GDNs	SGN	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	75%
	WWU	N/A	N/A	N/A	N/A	N/A	N/A	N/A	25%	90%
NG	National Grid	90%	50%	90%	10%	90%	90%	90%	75%	25%
	Average	75%	50%	75%	50%	75%	75%	75%	50%	50%

2.33. Table 2 above, shows how NWOs' results compare to the average results of other UK private sector funds. It shows that the majority of DNOs' performances would place them in the bottom 50 per cent of DB pension schemes per Hewitt's (i.e. in 50th percentile or below). This could either show that the schemes invest in less risky (return seeking) assets than UK plcs generally or that they have, on average, similar investment profiles but these are producing worse results. The latter could be an indicator of inefficient stewardship (the third pension principle).

2.34. Returns by asset class were also reviewed to see if NWOs are under-performing the average fund across all asset types. On average, we noted that NWOs have invested slightly less in equities, 5 percentage points across all years, than other UK plc pension schemes. This may confirm GAD's position that the investment profile of the schemes were similar to average UK private sector DB pension schemes, after adjusting for the relative maturity of licensees' schemes. We also observed that the DNO with its scheme open to new members, is the only NWO to have higher investment in equities than the UK average across all years. It is also the only DNO to have a scheme that remains open to new members and therefore could be expected to be following a bolder investment strategy, consistent with GAD's comments, based on the profile of its members. Interestingly, its average remaining active service life is comparable to other NWOs and compared to other NWOs the performance of the WPD scheme is around average (their scheme's average ranking is 6).

2.35. We have also compared the actual returns schemes achieved in 2008 to the returns we would have expected them to see given their mix of assets if each asset class had performed in line with the median average returns in Hewitt's survey. For example, the median return on equities in 2008 was minus 8.8 per cent, this is then multiplied by the proportion of the scheme's total investment which is in equities.

Table 3: Investment returns

	Actual 2008 return (%)	Return if return by asset class equal to Hewitt's median (%)	Percentage-point difference
E.ON ESPS	5.2	-3.8	9.0
WWU	-3.3	-8.3	5.0
SP Dist	2.4	-1.3	3.7
SSE Hydro	2.6	-0.4	3.0
Manweb	0.5	-1.4	1.9
National Grid	1.7	0.3	1.4
EDF EFES	0.3	-0.8	1.1
SGN	-3.0	-3.2	0.2
WPD	-3.2	-2.8	-0.4
CE	-1.8	-1.1	-0.7
SSE Southern	-2.7	-1.4	-1.3
EDF ESPS	-3.3	-0.7	-2.6
ENW ESPS	-2.8	1.5	-4.3
UU ESPS	N/A	-2.1	N/A
NGN	N/A	-0.9	N/A
AVERAGE	-0.9	-1.9	1.1

2.36. The data above indicates that given the investment mix, on average, NWOs have outperformed expected returns when it is assumed each asset class was performing in line the average from Hewitt's survey. This could suggest that given their risk profile, NWOs are managing their schemes well and are outperforming expectations. This would imply that, as NWOs tend to underperform the UK average scheme overall, the difference may be due to a different investment mix. This data has limitations in that the NWO's assets classes may not directly correlate with those in the survey, as Hewitt's data is only a very high-level breakdown. A detailed breakdown of investment returns by asset class was not requested in our pension questionnaire and so we have restricted our analysis to the high level.

2.37. Overall, there appears to be no correlation between the proportion of equity investments and how well a fund does compared to comparators.

2.38. We also considered the role of pension scheme investment fund managers and whether different managers had any significant influence on scheme returns. We have limited information on who manages DNOs' DB scheme investments. However, for those schemes where we do have information we note that more than one advisor manages a scheme or a specific part of it. Thus DNO schemes, by employing more than one advisor, have mitigated the risk that inefficient individual managers cause bad performance.

Conclusions

2.39. Based on the available data, the analysis suggests that no one NWO is significantly out- or under-performing others on the management of their pension fund. No one NWO has consistently outperformed or underperformed the others over a long period.

2.40. Compared to the average UK private pension scheme in Hewitt's survey, NWOs have underperformed to the extent that they would be in the bottom half of Hewitt's sample of returns made by UK pension funds. This may be caused by a different investment mix likely to be driven by the need to match cash inflows with forecast payout requirements and the maturity of the schemes requiring more fixed returns on low risk investments. This appears to be supported by looking at expected returns for the NWOs given their investment mix. Whilst there is insufficient data to confirm whether this is the case, there seems to be no correlation between the proportion of equity investments that a scheme has and its average ranking over time.

2.41. There is mixed evidence on the investment manager's impact on individual pension fund performance. Most schemes have more than one investment manager for different classes of assets. We have not sought to ascertain schemes' policies for benchmarking or selecting and retaining investment managers. On balance, whilst generally under-performing, it is difficult to draw the firm conclusion that the DNOs are failing to ensure proper stewardship under principle two.

3. Way forward - options in setting pension cost allowances

Chapter Summary

In this chapter, we set out for consultation some high level options for treating pension costs and deficit repair costs in DPCR5 and subsequent price controls. We outline various different approaches we could take to incentivise NWO's management to manage the cost of pensions including maintaining our current approach.

Question 1: Views are invited on the options for managing pension costs and whether retaining the status quo is, or is not, an effective incentive on management to manage pension costs?

Question 2: Views are invited on the options set out for setting ex ante allowances and whether this set of options provides a good balance between allowing the NWOs funding for existing commitments, whilst moving towards a more incentivised approach for future commitments?

Question 3: As an alternative to specifically adopting one or all of the options set out, should we introduce a form of menu regulation where NWOs could select one of the options? NWOs choosing a de-risked approach would receive a lower allowed return than those that did not.

Incentivisation of the different elements of pension schemes

3.1. To help stakeholders understand the issues and the options, it is helpful to split pension costs into three elements:

(1) liabilities associated with past pension provisions

(2) ongoing costs of DB schemes; and

(3) the cost of servicing defined contribution schemes.

3.2. The high level options are: to maintain the status quo,; to introduce incentives on one, two or all three of these elements; or to allow NWOs the choice but with an adjustment to cost of capital for companies opting for the status quo as it significantly de-risks them.

3.3. We think the companies have more control or influence over some elements of pension costs than others, so if the outcome is to implement incentives it may be appropriate to have different strengths of incentives for these different elements.

3.4. We emphasise that existing liabilities will be funded and are not being put at risk. We are simply consulting on options that might be more effective at making

NWOs manage their pension costs on customer's behalf and that for future liabilities would make sure NWOs arrangements track what is happening to pension arrangements in other comparable companies.

3.5. We summarise the options in the following table:

Table 3.1: Pension allowances and incentives options

Pension costs element	**Existing approach (DPCR4)**	**Potential incentivisation**	
		Ex ante	**Ex post**
I. Payment of any deficit arising on accrued liabilities to date (which would be at date of relevant price control)	Accept actuarial valuations (allowing full true-up) of regulated fractions, subject to ERDCs	(A) Accept funding of deficit at 31 March 2010[13], decision on using conformed valuations. (B) Decision to make on recovery periods, either: (i) use actual deficit repair period of company scheme (ii) use a notional deficit repair period	Modest symmetric sharing factor – for example shareholders for example bear or gain 2 to 10 per cent of any difference between actual contributions and allowed contributions

13 To determine the deficit attributable to all of the pension commitments that have been made at that time. The 31 March 2010 cut off date is for DNOs and would be end of existing price control reviews for TOs and GDNS.

II. The ongoing costs (and then any incremental deficit that subsequently arises) of a defined benefit scheme	Accept actuarially recommended contribution rates, apply to our estimate of salaries, full true-up	Allow NWOs a fixed allowance with no true up Two options: (1) Set allowances in line with expected contribution rates (2) Benchmark and make fixed allowance based on either (a) pension costs, or (b) total employment costs	Apply the same incentive rate as all other costs or a lower rate accepting NWOs have less control because of legislation.
III. The cost of servicing a defined contribution scheme	Accept existing rates, apply to our estimate of salaries, full true-up		Same incentive rate as all other costs including total employment costs[14]

NWOs' control over these costs

3.6. **Liabilities for past pension provision:** NWOs have limited ability to control the costs in I) above as they cannot retrospectively alter accrued pension rights. They have some influence over investment management and effective investment management can manage and even reduce the size of the deficit. They may also have some influence over the speed with which any deficit is repaid, depending on the outcome of discussions with scheme trustees and the Pension Regulator.

3.7. NWOs can influence the trustees' views on the appropriate actuarial assumptions to use; and the deficit funding period that they can afford. With one exception, they have mitigated these costs by closing the schemes to new members. They cannot without the consent of trustees and members amend scheme benefits or future accruals.

3.8. **The ongoing costs** (and then any incremental deficit that subsequently arises) of a defined benefit scheme: The NWO has more control over these costs. It can, for example, seek agreement (under the scheme rules) to raise the level of employee contributions to the scheme, (although the Protected Pensions Legislation may limit the scope for the network companies to do this) or it could seek to agree with unions and employees to restrict wage increases in recognition of the value of the pension arrangement relative to other employees or other companies without defined benefit

14 Indicative rates are 30-47% in DPCR5 Initial Proposals, whilst the current rate in TPCR is 25% and in GDPCR, 33-36%

pension schemes. Some companies in other sectors have closed their schemes even to existing members, so that there are no further liabilities being accrued.

3.9. **The cost of servicing a defined contribution scheme:** These costs should be no harder to control than salary costs, as the company is not making a promise to fund an uncertain eventual liability, but agreeing to pay in a specific amount to a scheme.

Potential incentivisation

3.10. In the light of DNOs' ability to control or influence each of the three options for incentivising ex ante allowances in respect of these three categories are set out below:

1. **Liabilities for past pension provision** It may be appropriate to draw a line at the end of the current regulatory periods, which in electricity distribution would be 31 March 2010 and determine the deficit attributable to all of the pension commitments that have been made at that time. Broadly speaking this would cover any deficit attributable to all of the accrued pension rights of former and existing employees at the end of the DPCR4 period. Consistent with our pension principles, we consider that we have an obligation to fund the efficient costs associated with this deficit. GAD's review suggests that broadly, the terms of the schemes and the funding of them have not been significantly different to those seen in comparable FTSE100 companies. We consider that it is possible to use actuarial calculations to ring-fence the deficit at a given date to be able to distinguish movements in the value of this deficit from any incremental deficit (or surplus) arising from accruals of benefits after this date.

2. **The ongoing costs** (and then any incremental deficit that subsequently arises) of a defined benefit scheme. Most energy network companies have taken the major step of closing their defined benefit scheme to new members (except WPD). Nevertheless, the NWOs will continue to have to make contributions in respect of employees who were in these schemes before they were closed.

3. **The cost of servicing a defined contribution scheme.** A similar approach to incentivisation to that applied to salary costs is appropriate, and has already been adopted in GDPCR 2008-13.

3.11. For each of these three elements we invite views on:

- How we should set ex ante allowances. We have to make decisions about the ex ante allowances whether we take a risk-sharing approach or not. The approach we take may have an impact on how effectively a risk-sharing approach incentivises NWOs in practice and;

- Whether we should put more explicit incentives on NWOs through some element of risk-sharing than under the existing application of our principles. The level of incentivisation that would be appropriate is directly related to the company's ability to manage these costs. It is not our intention to place strong incentives on past liabilities as there are limited (but still some) steps NWOs can take to control these costs. The incentive would work through the extent to which we made ex post adjustments for the out-turn costs being different from ex ante allowances.

3.12. Below we discuss these two questions in respect of each of the three elements of pension costs.

Ex ante funding

Liabilities for past pension provision

3.13. Decisions we take about the valuation method can have a significant impact on the ex ante allowance, regardless of which of the options we follow at a price control review. Our current principles are not prescriptive on how the liability is determined, and so if we retain full true up, we consider that there are a number of choices to be made regarding the initial valuation and the funding period. These are discussed in chapter 4. If we introduce incentives, then we consider that a conformed valuation method would be most appropriate.

3.14. A conformed basis would help to minimise differences between schemes, by requiring each scheme of which an NWO is a sponsor to undergo a valuation at a consistent date and with common actuarial assumptions. This would allow us to ensure that for example, the assumption of salary increases are consistent with those made by Ofgem in the price control review, although we recognise that the actuarial assumptions may apply over a different time frame than the five years of a price control review. We recognise that for some schemes, there may be some elements of the valuation where it would be appropriate to allow variations from the common set of assumptions. An example would be where schemes have evidence of a specific set of mortality assumptions that are applicable to their members. It would avoid the risk of NWOs submitting an overly conservative valuation of the deficit for a price control review in order to attempt to maximise their ex ante allowances.

3.15. In considering whether to adopt this option, we consider whether this is proportionate and is not unduly increasing the regulatory burden. If this is undertaken at the same time as scheme's annual accounts or periodic valuations under S224 Pensions Act 2004, this may not significantly increase the burden and potentially could be just one of the assumptions sets that scheme actuaries consider in their advice to trustees / sponsors. This option is certainly not intended to cause an additional valuation exercise to have to be performed over and above those that the trustees are required to commission or to prescribe assumptions to be used in any valuation commissioned for other purposes. However, we acknowledge that we can only require action by the licensees and that this option would require the licensee to procure the co-operation of the scheme trustees. We accept that that the scheme should not bear the cost of a valuation on a conformed basis. We invite views on this approach.

Deficit Funding Periods

3.16. In the current volatile economic conditions, where the estimate of deficits can move significantly, we need to strike a balance between funding recovery of the chosen estimate at a fast rate - taking into account TPR's requirement that when a deficit arises, trustees should aim for it to be repaired in as short a period as a sponsor can reasonably afford - and funding deficits over a longer period of time, pending a clearer understanding of the ultimate cost. The latter may also be more affordable for consumers in the current difficult economic circumstances, but may run the risk of future customers having to pay a significantly greater amount.

3.17. In setting revenue allowances, we need to address what is an appropriate recovery period in the context of what is reasonable for the NWOs' customers to bear, given that we only have an estimate of the ultimate cost and this estimate may be volatile and uncertain. TPR, on the other hand, has to consider what is reasonable for the financial security of the members in the pension scheme. In normal circumstances, the longer the delay in recovering a deficit, the greater is the risk that the employer may fail before the deficit has been recovered. This does not appear to be the case for NWOs who enjoy a monopoly of essential services and guaranteed revenue allowances with Ofgem setting price caps under a duty to ensure that the regulated businesses, if run efficiently, can finance their functions. There may, therefore, be an argument for saying that the regulated businesses do not need to remedy the deficits as fast as a non-regulated business. Although for this argument to be true we need to understand in greater detail what would happen to pension liabilities in the event that a poorly run, inefficient network company was placed into special administration. We are therefore reviewing the interaction of the energy administration regime and the PPF and pension regimes to confirm the security afforded if a NWO fails.

3.18. The NWOs may argue that an assumption of an extended deficit recovery period in setting price controls may expose them to carrying the cash cost of a shorter recovery period because the trustees have already agreed a recovery plan. The Pensions Act 2004 requires an actuarial valuation at least every three years and, in the absence of an annual actuarial report updating any developments, it requires the valuation every year. Trustees can, therefore, commission a valuation as often as every year. Moreover, unless the deficit is unchanged (apart from the recovery payments made since the last valuation), there is bound to be a new recovery plan. In the case of a regulated company trustees may have regard to the resetting of its price control. One of the main criteria by which a revised plan will be assessed is affordability. Options include setting the funding period according to the -

1. Period agreed by the trustees and employers in the deficit recovery plan. This will vary but on current TPR guidelines to trustees, may be as short as sponsors can afford. We consider that to protect consumers it is reasonable for us to fund NWOs over a different notional period to that approved by trustees.

2. A notional period set by Ofgem. This could be derived from the average of all schemes covered by a given price control. Alternatively, we could adopt a different period. For example, a period of ten years reflects our thinking above and is also the TPR trigger point for reviewing the deficit recovery plan. Therefore a ten year period may avoid exposing the scheme trustees (or the NWO) to the risk or burden of greater scrutiny by TPR. Ten years is also the indicator above which TPR will review the funding to assess whether appropriate to the circumstances of the scheme and sponsor and satisfies the aim of funding deficits in shortest reasonable period. It has merit in that it may influence trustees and sponsors to adopt a longer period than otherwise would be the case. It is currently longer than most, but not all, schemes' funding periods and would benefit consumers should the deficit decrease in the period at the subsequent triennial valuations. In our view, this period sends a strong message to sponsors and trustees to accept that consumers' ability to pay should be a key factor to be taken into account, especially if factored into the employer's price control. Views are invited on whether it is acceptable for us to spread existing deficits with an approved funding period over a different notional recovery period for the purposes of the price control, and whether this would only be appropriate when a new valuation is expected to be approved.

Ex post adjustment

3.19. A small element of risk sharing might be appropriate, with shareholders bearing between 2 and 10 per cent, of the risk that the actual cost turns out to be different. The remainder of any variation would be subject to ex post assessment as before. Alternatively we could make a full ex post adjustment as we do currently.

The ongoing costs of DB schemes

Ex ante funding

The options are as follows:

1. We set allowances in line with NWOs' own forecast contribution rates, typically then applying those to our estimate of relevant salary costs (determined as part of our overall assessment of cost allowances). This guarantees full funding for NWOs at current rates, as long as they meet our efficiency targets. If they fail to manage their overall employment costs however, then this may not represent full funding. We would expect forecast contribution rates to be based on existing contribution rates, representing the most recent full assessment of the ongoing funding requirement. Where NWOs presented higher forecast contribution rates, the onus should be on the NWO to justify forecast different from the existing rate, not merely by reference to an actuarial calculation, but with an explanation of why the variation should be considered a better estimate than current agreed rates.

2. We set allowances by benchmarking pension costs or total employment costs. As suggested above we could require a valuation be carried out on a conformed basis to facilitate comparisons. This would not imply that the schemes ought to set the actual contribution rates at the level that resulted from those valuations. However, to the extent that the actual contributions differed from the rate implied by the calculations on the conformed basis, the NWO would bear the

consequences of the difference (subject to any ex post adjustment - full ex post adjustment largely removes the incentives created by this method). The advantage of this approach is that we can put incentives on the NWOs to find efficient solutions without Ofgem attempting to make judgements about particular decisions.

Ex post adjustment

3.20. In this second case, it may be appropriate for the shareholders to bear more of the risk than for the deficit on accrued benefits, although again, this is only the risk that a fair ex ante allowance does not turn out to be adequate. Alternatively we could make a full ex post adjustment as we do currently. In GDPCR, this is done by reference to changes in the contribution rate, which allows companies to keep the full benefit of any employment cost savings, whilst in DPCR4 and TPCR it is done by reference to the cash contributions.

3.21. In setting allowances, we should be mindful of the difference between our position and that of other regulators who, as noted in chapter 1, are notably less generous to shareholders in the balance of risks and rewards between them and their consumers. If we maintain the status quo this arguably means that the NWOs face less risk than other regulated utilities and we are minded to take this into account in setting the cost of capital.

The cost of servicing a defined contribution scheme

Ex ante funding

3.22. A similar set of options applies in this case. We can either accept agreed contribution rates and apply them to our estimate of relevant salary costs (determined as part of our overall assessment of cost allowances) or we can benchmark costs including pension contributions and apply the results accordingly. For the avoidance of doubt the latter approach would not mean that we are suggesting that all NWOs should adopt the same contribution rate as the companies setting the benchmark, but that they would all need to consider the implications of having a different rate on their overall efficiency. In the case of transmission companies, where we do not always have a direct comparator, we may carry out a total employment costs review that compares against employment costs in similar industries.

Ex post adjustment

These costs would be treated in the same way as the underlying employment costs. To the extent that they related to costs or cost activities that were not subject to true up (typically operating expenditure activities) there would be no ex post adjustment. To the extent that they related to costs or cost activities subject to a fixed incentive rate (typically investment activities and related indirect costs), they would be subject to the same rate of incentive and an ex post adjustment would be made accordingly.

Menu regulation and the impact on the cost of capital

3.23. Finally, a further option is to offer companies a choice between full true up and risk sharing (over some or all three of the pension cost elements discussed above) with a consequential adjustment to their allowed returns for the differential risk. Calculating the appropriate adjustment will not be straightforward, but companies' responses to such a choice will reveal useful information about the value they place on the insurance provided by a full true up, allowing recalibration of the adjustment at subsequent price controls.

3.24. We invite views on whether this set of options provides a good balance between allowing the NWOs funding for existing commitments, whilst moving towards a more incentivised approach for future commitments. That approach requires NWOs to consider whether it is efficient and appropriate to continue to incur further defined benefit commitments, trading-off the risks of funding such obligations with the benefits to salary costs, staff retention and productivity that such schemes may provide. It is particularly important to ensure that NWOs with open final salary schemes are operating under a price control that encourages management to weigh up these factors in the same way that an unregulated company would. We consider that these options offer a useful amount of flexibility for setting allowances. Do respondents agree that it is appropriate to keep all the options together or deal with each of them separately?

Options for DPCR5

3.25. Whilst we are consulting on these options, we have included a provisional allowance for pensions in DPCR5 initial proposals which will be published on 3 August 2009. For deficit recovery in particular, there is a large difference between the costs implied by the DNOs' existing recovery plans and their forecast of future deficit recovery costs – anything up to £3.3 billion as at March 2009, before application of the regulated fraction. The pension funding amounts currently in the initial proposals are some £1.4 billion for deficit repair and £0.5 billion of ongoing funding costs for 2010-15, although DNOs' projections were higher. This shows the magnitude of the costs that DNOs are seeking to recover from customers for this element of costs. We have as a marker in our Initial Proposals taken the DNO's projections and adjusted for our provisional view of the regulatory fraction and the remaining effect of unfunded ERDCs. However, we have not made a decision on this matter and so this provisional choice should not be seen as our minded to position. We will clarify this in October.

3.26. We recognise that some of the options suggested above, such as the use of conformed valuations and total employment cost benchmarking, may not be achievable between now and Final Proposals. However, even if we have a more limited set of choices for DPCR5, we want to use this consultation process to decide our preferred approach for subsequent price controls.

4. Further issues

Chapter Summary

In this chapter, we set out some further issues that we encounter in setting pension allowances for price controls, several of which were raised in the initial consultation. These include assessing the regulatory fraction, appropriate actuarial valuation, deficit funding periods, treatment of the PPF levy and scheme administration costs, stranded surplus, buy-in / buy-out of scheme liabilities, failure of stewardship, unexpected lump sum deficit payments, early retirement deficiency contributions, and the tax treatment of pension costs.

Question 1: We invite views on whether it is appropriate for consumers to fund any additional costs arising from a buy-out or buy-in and, if so, over what period should the costs be spread so as share the burden between current and future generations of consumers that may benefit?

Question 2: We invite views on which is the most appropriate valuation to use in setting ex ante allowances and whether this should depend on employers' actual funding being revised to match that based on that valuation?

Assessing the attributable regulated fraction

4.1. In applying this principle, we ensure that only the pension costs specifically of the transmission and/or the distribution business are funded by consumers. We will not fund pension costs related to self-financing excluded services, distributed generation, metering, de minimis activities of the NWO and of unregulated businesses in the same scheme.

4.2. There are a number of other factors which may influence the attributable regulatory fraction. These include structural changes to the scheme, such as mergers or demergers, which are discussed below.

4.3. It is our view that the regulatory fraction determined in setting allowances should be reviewed to assess the ex post adjustment when there have been structural changes to a scheme and at each triennial valuation within a price control period. We will also review and adjust for movements in the previously unfunded ERDCs and assess how they have evolved.

4.4. Structural changes may occur when:

- schemes merge,
- schemes demerge,
- members are transferred in or out in bulk,

- there is a change of ultimate controller, and
- buy-in/buy-out of any part of the scheme membership

4.5. We expect NWOs to maintain appropriate records to enable this assessment. In the absence of detailed records, we would apply our own judgement. We would revise the allowed proportion and apply it immediately within a price control period and for computing the ex post adjustments. We intend that this policy applies to DPCR4 as the allowed proportions set out in tables 8.3 of the Final Proposals were appropriate for setting the allowances but not explicitly stated to be used in determining the ex post adjustments.

4.6. Specifically at DPCR4, the DNOs historic records did not necessarily identify the split between regulated and unregulated activities and a pragmatic solution was applied. One option is an actuarial assessment and valuation at each trigger point above to determine the revised allowed proportion. Respondents suggest that it is not cost effective for NWOs to have an annual actuarial assessment of this split. We will review each occurrence on its merits and would expect sponsors to approach us at an early stage to discuss the possible impact on their allowances.

4.7. In DPCR5 initial proposals, we have not had robust evidence from all DNOs in respect of their regulated fractions, and so the current estimates are subject to change. We have excluded pension costs related to the provision of excluded services.

Appropriate actuarial valuation

4.8. At the time of a price control review, licensees are required to provide up-to-date actuarial calculations (including the most recent formal actuarial valuation of the relevant schemes) to support their estimates of the cost of deficit recovery. Our reviews of pension scheme valuations at previous price controls suggested that they all fell within the bounds 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 increased pension allowances.

4.9. At DPCR5, DNOs have requested that we should use the latest interim valuations, rather than the **most recent full actuarial valuation,** and their forecasts of the deficit funding. They consider that because of the current upwards movements arising from the volatile economic conditions the last full actuarial valuation will not reflect their future funding costs, which they would have to fund until the ex post adjustment at the next price control. We have flexibility in considering the appropriate valuation to use in setting allowances provided it be supported by up-to-date actuarial valuations. Our decision on this matter may influence the effectiveness of any incentive placed on NWOs. In considering which valuation is the most appropriate there are a number of options:

1. **Last triennial valuation:** This was the basis used at DPCR4 as the timing meant that it was the most up-to-date valuation for many schemes, whilst also being the basis of deficit recovery plans. Consumers might benefit at DPCR5 from lower ex ante allowances under this approach as most valuations are at 31 March 2007 after which date estimates of deficits have increased materially. At future price controls depending on the timing of valuations and on market conditions, the opposite may be the case. If we do not introduce incentivisation, then this may only be a timing issue for NWOs who have to fund higher actual deficits in the short-term.

2. **Latest interim valuation update: Where the estimated value of deficits is expected to move significantly, and especially in cases where a deficit was not apparent at the last triennial valuation,** this approach may avoid reliance on an out-of-date valuation, whereas the latter leaves the NWOs exposed to the timing issue of higher cash outflows during the price control, may upset the balance of funding between current and future consumers. On the other hand, unless an interim valuation update leads to the payment of higher contributions, the deficit calculated by the interim exercise will not correspond to the actual cash payments into the scheme. In addition, at times when deficit estimates are volatile, as has been the case recently, it is not clear that a more recent estimate is a better proxy for the next triennial valuation.

3. **Projections of subsequent movements** in deficits during the forthcoming price control period. As these are by their nature unlikely to be supported by actual actuarial valuations, they would not necessarily provide a robust basis for funding deficits; and would not correspond to actual cash payments into the scheme.

4. **Conformed basis**, as set out in chapter 3.

4.10. We invite views on which is the most appropriate valuation to use in setting ex ante allowances and whether this should depend on employers actual funding being revised to match that based on that valuation?

Deficit funding periods

4.11. In chapter 3, we addressed the issue of which of three funding periods we have the option to apply in setting ex ante allowances. In addition to the (i) actual deficit repair period of company scheme; (ii) the average deficit repair period of all schemes; or, (iii) 10 years, there is a fourth option: (iv) remaining active service lives of actives. This was the DPCR4 basis but may not be compatible with TPR guidelines. This is little different from setting a defined period and remaining active service lives does not mean that deficits will not increase once all current actives are pensioners. Indicators are that the average is around 9 years. It should not be considered the maximum period. Its only merit is that it is the period determined by a previously applied and accepted methodology.

4.12. In TPCR4, option (iii) was applied. In DPCR4, option (iv) albeit with 13 years as the remaining active service life for all but one DNO. In DPCR5, we are currently using option (i) albeit with DNOs projected repair periods post for the next triennial valuations.

Pension administration costs

4.13. Views were sought on whether there was any significant benefit in reviewing these for efficiency. Respondents have stated that in their view, the trustees were sufficiently incentivised to ensure that the scheme's costs are efficient. There are also the practical aspects in the implementation of a review, e.g. our ability to benchmark effectively these costs. One issue raised was that in part, they will vary dependent on a scheme's investment strategy and many investment fees are performance related. We will normalise the treatment of pension administration costs paid directly by licensees compared to those funded through increased employer contributions in setting allowances. In future, both will be treated as pension costs. We retain the option to incentivise these costs separately but given their relative immateriality, we are unlikely to do so unless there are signs that NWOs are failing to exert control over these costs.

PPF Levy

4.14. It is unlikely to be appropriate or cost effective given the historic value of the levies to subject these to an efficiency review. This is especially so for the risk based element which is outside the control of sponsors and trustees being dependent on the requirements of the PPF. Respondents suggested that we should recognise that sponsors and trustees are doing all they can to minimise PPF levy. We will continue to monitor their actions to mitigate the risk based element of the levy where they can affect the levels, e.g. their Dun & Bradstreet Failure Scores (used to measure a company's insolvency risk) where a low score contributes to higher rate of the levy, clearing outstanding county court judgements.

4.15. At DPCR5, for initial proposals, we have capped the ex ante amount due to significant variations in the basis of forecasting levies, but will adjust ex post in line with other pension costs.

Stranded surplus

4.16. In the May DPCR5 paper, we reviewed the possible actions available to trustees were there to be a stranded surplus and NWOs behaviour were we to reduce future funding to NWOs for the benefit of consumers.

4.17. Respondents stated that licensees take this issue very seriously. In practice, trustees who have obligations to protect scheme members, are likely to de-risk their investment strategy to minimise the surplus, using measures in place such as reducing risk as funding levels improve. Notwithstanding this, it is our intention to monitor the schemes' position and we would expect symmetry in treatment with funding of deficits to share the benefit across members and consumers. As such, if a scheme were in surplus for a given period we would consider our options when setting allowances such that consumers would benefit and the shareholders would cover the cost if contribution levels were not adjusted. Sponsors and trustees decisions would not be fettered, although they may be influenced by our treatment, as we do not have or seek the power to direct them. We do not consider that reducing risk is always efficient if it leads to higher funding and deficits. Each instance would be reviewed on case-by-case basis.

Buy-ins / buy-outs of pension schemes

4.18. In the consultation, we invited views on whether a new principle was required as the treatment of a buy-in or buy-out[15] is not covered explicitly by the existing principles. They fall within the scope of principles 1, 2 and 5. Respondents suggested that at present these are unlikely to happen on the near future. We are minded not set to out a new principle. We do however, invite views on whether it is appropriate for consumers to fund any additional costs arising and, if so, over what period should the costs be spread so as share the burden between current and future generations of consumers that may benefit?

Failure of Stewardship

4.19. Stewardship is the responsibility of the trustees. Failure may be less likely to occur given the trustee knowledge and understanding requirements under the Pension Act 2004. Our principle states that any excess costs arising from material failure in the responsibility for taking good care of pension scheme resources will be disallowed. Examples might include items such as recklessness, negligence, fraud or breach of fiduciary duty. To the extent that we adopt an incentivised approach to the deficit, it may obviate the need for us to carry out a detailed assessment. If we do not, we reserve the right to make adjustments to allowances if we observe any of the following:

- poor investment returns over a long period, e.g. greater than a single price control. Whether the scheme investment managers are underperforming against their peers or the market and expectations and their performance has not be reviewed or benchmarked at appropriate intervals,
- not matching investment/returns to fund future liabilities as they fall due,
- material increase in deficits and need for increasing the funding,
- maintaining a higher balance of investments in riskier assets compared to investment returns and which do not match future liabilities,

[15] . A buy out of pensioner liabilities by annuities, where the trustees discharge the scheme liabilities through the purchase of annuities from a regulated insurer, so that the insurer assumes responsibility for making payments of members' benefits.

- accepting transfers in at under value, and
- making transfers out at over value.

Unexpected lump sum deficit payments

4.20. These tend to occur in instances in change of corporate control. Whilst one can understand the trustees taking the opportunity to repair the deficit faster, it is not clear why consumers should pay an accelerated profile.

4.21. Our current application of the principles is to review the payment of the lump sum compared to what the position would have been if the deficit had been spread over a number of years. This is to ensure that consumers have either positively benefited from, or have not been disadvantaged by the accelerated funding. Where a company cannot satisfy us that the accelerated payment has been in the interests of customers (as opposed to shareholders or scheme members), we will treat the payment as having been made over the period according to the original deficit recovery plan.

Early Retirement Deficiency Contributions (ERDC)

4.22. As set out in 2003, these are for the account of shareholders as from 1 April 2004 across all price controls and we will maintain this principle. See 2.28 of previous pension consultation.

4.23. For DPCR5, we are examining the arguments advanced by DNOs and the underlying methodology for assessing whether the amounts for ERDCs previously excluded in computing the allowable proportion have reduced, either because DNOs have been paying the unfunded balance from the disallowed proportion of deficit payments, or have increased in line with the deficits. DNOs suggest variously that they have been paid off either completely or partially and should no longer be a factor in computing the allowed proportion. We will set out our minded to position in September.

Tax treatment of pension costs

4.24. It is useful to set out our position on the tax treatment of deficits in modelling revenues. The basic assumption is that the distribution and/or transmission business is a standalone taxable entity and the cash costs of pensions are deductible in accordance with legislation at 100 per cent, subject to the recently introduced irregular payment rules, which spread the relief over more than one year for significant increases. We will follow tax legislation extant at the relevant price control. Ex post adjustments will be made net at the applicable rate of corporation tax for each year to avoid double counting the tax affect on the revenues.

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. 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. Responses should be received by 14 September 2009 and should be sent to:

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

1.2. 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.

1.3. 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.

CHAPTER: One

Question 1: Should we continue with the current approach, which puts the onus on us to review information submitted by the NWOs to make judgements of efficiency or otherwise, or should we introduce some incentives on NWOs to manage existing and future pension liabilities?

CHAPTER: Three

Question 1: Views are invited on the options for managing pension costs and whether retaining the status quo is, or is not, an effective incentive on management to manage pension costs?

Question 2: Views are invited on the options set out for setting ex ante allowances and whether this set of options provides a good balance between allowing the NWOs funding for existing commitments, whilst moving towards a more incentivised approach for future commitments?

Question 3: As an alternative to specifically adopting one or all of the options set out, should we introduce a form of menu regulation where NWOs could select one of the options? NWOs choosing a de-risked approach would receive a lower allowed return than those that did not.

CHAPTER: Four

Question 1: We invite views on whether it is appropriate for consumers to fund any additional costs arising from a buy-out or buy-in and, if so, over what period should the costs be spread so as share the burden between current and future generations of consumers that may benefit?

Question 2: We invite views on which is the most appropriate valuation to use in setting ex ante allowances and whether this should depend on employers actual funding being revised to match that based on that valuation?

Appendix 2 – Summary of responses to first consultation

1.1. A brief summary of the consultation responses to the August 2008 consultation is provided below. Some respondents went into detail about what they have done to ensure their pension costs are on an economical and efficient basis and what licensees should do. We have considered these as part of our review of pension costs.

1.2. Respondents preferred the status quo with minor application changes where currently unclear or not defined and any significant changes dealt with by RPI-x@20 review. There were a variety of views with one respondent suggested that NWOs were not actively pursuing all potential savings and Ofgem's approach should be to force companies into action by monitoring actuarial assumptions and competitive benchmarking. The union respondents were concerned with protecting their members' pension schemes.

CHAPTER Three:
Question 1: Have we identified the key issues with the current pension principles?
Respondents agreed that we had identified the key issues although several respondents made pertinent observations around the principles. Some companies observed that their schemes are already effectively operating on a commercial basis as the regulated part forms only a proportion of the overall.

Question 2: Do the principles need amending, and if so, what changes are required?
In general, it was felt that the way the principles were applied should be examined rather than the overall principles.

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?
Respondents' views were that any major changes should be dealt with in RPI-x@20 to ensure regulatory continuity; no major changes to pension principles should take place as part of DPCR5.

CHAPTER 4:
Question 1: Should we set a generic deficit funding period, e.g. maximum assumed by TPR, or accept that proposed by the individual scheme actuaries?
A scheme specific approach was widely advocated.

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?
The consensus view was for the preservation of status quo. Some respondents agree with spreading over a reasonable 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?
Respondents' views were that this should be by reference to the actual cash payments and not be reference to the contribution rate.

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?
Normal pension costs should "capitalised" into RAV. Deficit repair cost should be opex,(i.e. pay-as-you-go basis), as passing any repair costs into RAV spreads the cash recovery over too long a period and does not incentivise employers.

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?
This question was not answered directly. There was a consensus against benchmarking as, in their view, licensees take all reasonable steps to mitigate the costs of the levy.

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?
Respondents stated that administration costs should not be subject to efficiency review as it was their view that companies and trustees are doing all they can to minimise both the PPF levy and administration costs.

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?
General principles were broadly favoured but that these will then need to be applied on a case-by-case basis, as respondents were not convinced one-size fits all will work.

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?
Respondents suggest that this is too complex, likely to be expensive and may not deliver the required split as actuaries cannot attribute deficit due to the lack of robust historical records back to 1990.

Question 9: Where a licensee is taken over do the principles effectively deal with the treatment of any additional pension deficit repair payments?
The view was that the principles probably did not. There was support for the development of a specific principle, which should include dealing with additional lump-sum payments and the spreading thereof; but that there may still be need for case-by-case treatment.

Other question raised in the text:

Buyout: Should additional principles be developed or do the existing principles cover effectively?
There were mixed views, either possibly develop guidance but this was generally considered this was too expensive an option, as insurers look to minimise their risk and adopt cautious approach. Currently this was an unlikely option for NWOs to take.

Common valuation basis: Should Ofgem apply a common valuation basis in assessing pension cost allowances?
This was not supported and there was concern that such an approach could influence trustees' views adversely.

Stranded surplus: Should there be a basis for sharing any future stranded surplus accepting trustee's rights under the Pensions legislation?
Respondents' view was that surpluses and deficits are viewed as asymmetrical and that there is no likelihood or requirement for scheme trustees to return a surplus. Respondents reiterated that customers have benefited in the past from surpluses reducing contributions levels and could do so again.

Appendix 3 - Current pension principles

Defined Benefit schemes

Principle 1 - Efficient and Economic Employment and Pension Costs

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

1.1. Consumers should not be expected to pay the excess costs of providing benefits that are out of line with 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.

1.2. 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

1.3. It is for shareholders, rather than consumers of the regulated services, to fund liabilities associated with businesses carried on by the wider non-regulated group. This includes businesses that were formerly carried on by the same ownership group and have been sold, separated and / or ceased to be subject to 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.

1.4. 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

1.5. 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.

1.6. 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.

1.7. 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). Therefore, it would 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

1.8. 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.

1.9. 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.

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

1.11. The allowance for pension costs at each price control review will be based on the cash funding rate recommended by the most recent [16] actuarial valuation then available for each company's scheme (including the most recent formal actuarial valuation, usually the latest triennial valuation).

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)

1.12. 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.

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

1.14. 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.

1.15. 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.

1.16. 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

16 Although which valuation is now the subject of this review.

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.

1.17. 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.

1.18. 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.

1.19. 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).

1.20. 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.

1.21. 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.

1.22. 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

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

1.24. 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 reorganisation which have been offset by use of surpluses, rather than being funded by increased contributions.

1.25. 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 had previously considered that 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). We are not convinced that this method remains appropriate and may be flawed. We are currently reviewing the basis as part of DPCR5 and will publish an update ion September; 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

1.26. 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.

Appendix 4 – 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.[17]

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[18].

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 existing and future consumers, 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[19];
- the need to contribute to the achievement of sustainable development; and
- the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.[20]

[17] entitled "Gas Supply" and "Electricity Supply" respectively.
[18] 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.
[19] 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.
[20] 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[21] under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and
- secure a diverse and viable long-term energy supply.

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[22] 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.

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

Appendix 5 - 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.

Ex ante

Refers to a value or parameter set down before the commencement of the price control period

Ex post

Refers to a value or parameter ascertained after the commencement of the price control period

F

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

NWO

Collectively the electricity and gas distribution and transmission network operators (DNOs, TOs, and GDNs).

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

Pass through (of costs)

Costs for which companies can vary their annual revenue in line with the actual cost, either because they are outside the NWO's control or because they have been subject to separate price control measures

Pension Protection Fund (PPF)

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

Salary Sacrifice

A salary sacrifice arrangement in respect of pension scheme benefits is where the member's salary is reduced by the amount of the member pension contributions that the member would normally pay, and instead the employer meets the cost of the member pension contributions.

Scheme sponsor(s)

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

T

Totex

Total expenditure, i.e. capex plus opex but excluding pension deficit repair costs.

TPR

The Pensions Regulator, established under the Pensions Act 2004.

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.

Triennial valuation

A detailed actuarial review of a pension scheme’s assets in comparison to its liabilities in present value terms. It is used to determine ongoing contributions and any deficit recovery plan.

Weighted Average Cost of Capital (WACC)

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

Appendix 6 - 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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