



Distribution network operators,
generators, transmission owners,
electricity suppliers, consumers
and their representatives and
other interested parties

*Promoting choice and value for
all gas and electricity customers*

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Date: 14 October 2010

Dear colleagues

Efficiency review of energy network operators (NWO) pension costs

As outlined in our decision document, *Price Control Treatment of Network Operator Pension Costs Under Regulatory Principles 76/10* dated 22 June 2010¹, we have commissioned the Government Actuary's Department (GAD) to conduct a high-level review of the reasonableness of NWOs pension costs.

We set out draft terms of reference at appendix 1 for this initial review and interested parties are invited to comment on them before GAD undertake the review. Responses should be received by 21 October 2010. They should be sent to: **William McKenzie, Senior Manager, Regulatory Finance, Ofgem, 9 Millbank, London SW1P 3GE**, or william.mckenzie@ofgem.gov.uk. Unless marked as confidential, all responses will be published by placing them in Ofgem's library or on the website. A short summary of the findings of the review will be published on our website alongside our ideas for how we might take the findings on board.

Any questions on this letter should be directed to William McKenzie who can be contacted on 020 7901 7220 or by email at william.mckenzie@ofgem.gov.uk

Yours faithfully,

Bill McKenzie

William McKenzie
Senior Manager Technical Accounting
Regulatory Finance, Smarter Grids & Governance

¹ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=119&refer=Networks>

Appendix 1: Draft Terms of Reference for efficiency review of NWO pension costs

1. Purpose

1.1. This document sets out the terms of reference for an initial reasonableness review of all NWO's principal defined benefit (DB) pension schemes as part of the price control reviews.

2. Background

2.1. As part of the review of our Pension Principles² and as outlined in the last electricity distribution price control review (DPCR5) final proposals³ and in our decision document, *Price Control Treatment of Network Operator Pension Costs Under Regulatory Principles 76/10* dated 22 June 2010⁴, Ofgem set out the concept of a trigger mechanism to highlight pension schemes where the movement in an energy network operator's (NWOs) DB pension deficit seemed to be out of line with the general market. This developed into an efficiency review, which will be used to determine whether a company's pension deficit repair costs are efficient and not unreasonable.

2.2. To undertake the efficiency review (following consultation with stakeholders) of the reasonableness of NWOs pension costs, we agreed that we would commission the Government Actuary's Department (GAD) to conduct a high-level review, albeit with different terms of reference to the previous review⁵ undertaken by them as part of the review of our Pension Principles. The review is to be based as far as possible on information in routine annual regulatory returns.

2.3. GAD is to be engaged to undertake the initial reasonableness review of energy NWO's DB pension schemes and specifically their funding costs. As part of this review process GAD will set out in advance its methodology for comparing NWO's pension costs. The initial review will highlight whether a company's pension costs fall outside the expected range.

2.4. Where the initial review indicates that there are grounds to believe the company's pension costs⁶ fall outside of the expected range, this will trigger a further in-depth examination to determine whether the company should retain any, or a proportion of, the apparent efficiency savings if outturn costs are lower than the allowances.

Similarly, an in-depth review may be triggered to determine the level of any additional funding if either the outturn costs are higher than the allowances or where the deficit has increased and either may be due to inefficiencies. Ofgem will determine the former, GAD's review covers the latter. The process can be shown as:

² see appendix one

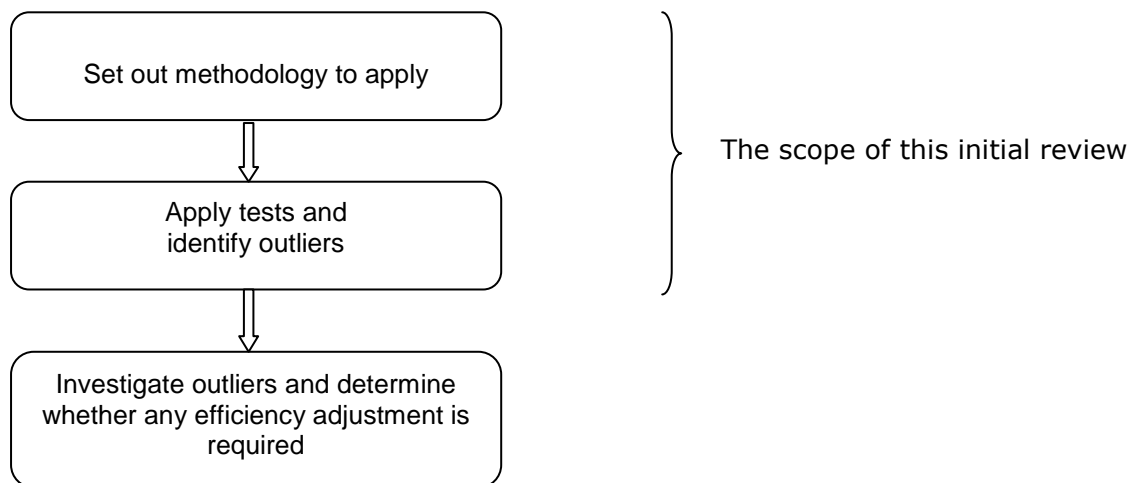
³ [Electricity Distribution Final Proposals 144/09 - 7 December 2009](http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=119&refer=Networks)

⁴ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=119&refer=Networks>

⁵ <http://www.ofgem.gov.uk/Networks/Documents1/Ofgem%20Report-finalsigned.pdf>

⁶ including ongoing service, pension scheme administration and deficit funding

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The second stage in-depth review will take place after completion of the initial report. If any NWO triggers a second stage review Ofgem will determine separate terms of reference for any subsequent consultancy support, as appropriate.

3. Objectives of initial review

3.1. The objectives of the initial review are to highlight those NWO DB schemes:

- where the movement in the deficit (reviewing separately the movement in underlying assets and liabilities) appears to be out of line with the general market; and,
- to identify whether any schemes' benefits, investment strategies, funding methodologies, funding assumptions, funding levels or standard contributions fall outside of the expected range compared to
 - (a) their industry peers, and
 - (b) publicly available information on other UK private sector DB pension provision;

and

- to set out in advance the methodology for the review, relating them to our pension principles⁷ and
- in particular, use this methodology to identify whether an NWO's pension costs fall outside of the expected range, taking into consideration the economic and efficient tests in principle 1 and the stewardship tests in principle 3 in which we have set out some indicators of failure.

3.2. The process should identify any scheme (and thus NWO's pension costs) that fall outside any of the expected ranges. If so, the initial review will inform Ofgem's determination of whether or not the NWO's pension costs should be subject to a second stage in-depth examination to ascertain whether:

- increased balances on deficits should be funded going forward,
- over-spends against allowances should be made good,
- under-spends against allowances should be clawed back.

⁷ Ofgem's pension principles are set out at appendix 1

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4. Scope of review

4.1. As part of this review GAD are required to undertake and consider the procedures and steps outlined below.

Analysis and methodology

Analyse the DB pension scheme data⁸ and compare licensees' pension arrangements (including actuarial assumptions and scheme benefits) with other NWOs and publicly available information on other UK private sector DB pension provision (subject to the availability of concurrent data). Identify any scheme and NWO's pension costs that fall outside of the expected range as outliers.

4.2. In discussion with Ofgem, construct in advance the methodology for the review, including:

- a) actuarial assumptions, particularly -
 - the discount rate, particularly with respect to the value placed on out-performance;
 - longevity aspects, particularly the allowances made for future longevity increases;
 - inflation;
 - salary increases,having regard to market conditions at 31 March 2010;
- b) benefits and contribution levels -
 - scheme benefits;
 - employers contribution rates;
 - employees contribution rates;
- c) investment strategies, in particular an NWO's investment risk relative to pension liabilities, using similar charts to those in the previous GAD report⁹;
- d) investment performance (this should be considered over at least one full price control period and preferably longer where comparable data is available – see caveats in Pension Principle 3);
- e) general overview of risk profile; and
- f) levels of scheme administration and investment management costs.

Scheme funding

4.3. GAD should review and report on whether the level of scheme funding has been, or appears to be, properly assessed on the basis of forward looking assumptions regarding long-run investment returns and other key variables.

4.4. In particular, GAD should review and report on the range of standard contribution rates and funding levels, identifying any clear outliers, considering separately the following determinants of those factors:

- Actuarial methodology and assumptions;
- Scheme benefits; and
- Investment strategies.

4.5. GAD should review any available *Employers' Covenant Review*, which has been produced for pension scheme trustees to obtain a view of the impact of any covenant

⁸ in the annual cost report submissions provided by NWOs to Ofgem, annual audited pension scheme accounts and the most recent valuations.

⁹ One comparing each NWO's exposure to return seeking assets (figure 3, page 23); and one comparing each NWO's exposure to return seeking assets against their percentage of pensioner liabilities (figure 4, page 24).

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factors on contributions and deficit funding levels/plans, and report on any identified weakness in the covenant or other issues which you consider should be brought to Ofgem's attention – see also 4.7f below.

Movements in assets and liabilities

4.6. A check should be made to ensure full reconciliation of the deficit balance between the latest valuation (or the preliminary) results with the previous one prepared by the scheme actuaries. The check should:

- a) identify any deficiencies or areas requiring additional explanation,
- b) (if possible) quantify the impact; and
- c) report thereon.

4.7. GAD should also identify the impact on the movements in the scheme assets and liabilities (and hence the deficit) from:

- a) external factors – changes in inflation, interest rates and general market conditions (market conditions being determined in a consistent manner at the start and end of the review periods);
- b) demographic assumption changes including longevity estimates, rates of retirement and other assumptions;
- c) factors relating to contributions;
- d) factors relating to investments;
- e) factors relating to benefits and changes thereto (e.g. scheme amendments); and
- f) factors relating to changes in the valuation methodologies - this would include changes in the margins of prudence in the valuation assumptions due to changes in a trustee's assessment of an NWO's covenant.

5. Output from review

5.1. GAD should draft a statement setting out its methodology for the review, to be published before NWOs are required to provide their pension data submissions.

5.2. We will require a publishable detailed report covering GAD's review of:

- How the objectives have been achieved;
- Each of the areas set out in the scope paragraphs above; and
- Specifically identifying any NWO's scheme(s) which is an outlier from any of the expected ranges, and any mitigating circumstances.

6. Timetable

6.1. Our proposed timetable is dictated by the timing of a combination of the NWOs price control pension data returns and the availability of draft actuarial valuations. It is primarily driven by our three forthcoming price reviews, all of which are being run concurrently:

- TPCR4 one year adapted rollover for 2012-13;
- The fifth electricity and gas transmission review (TPCR5) commencing 1 April 2013; and
- The second gas distribution review (GDPCR2) commencing 1 April 2013.

6.2. In order to meet our internal reporting deadlines, we propose:

Determine additional data requirements	early September 2010
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Determine methodology	31 October 2010
NWO pension data submissions including draft valuations received by Ofgem	30 November 2010
Work to commence	1 December 2010
Draft report for discussion	8 February 2011
Final publishable report	28 February 2011

Appendix 1 Ofgem's Price Control 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 the wider private sector practice, nor for excess costs avoidable by efficient management action. We will, unless inappropriate, benchmark total employment costs, to ensure companies have correct incentives to manage their costs, including pension costs, efficiently.

Pension administration costs

1.2. We will standardise the treatment of pension administration costs paid directly by licensees compared to those funded through increased employer contributions to the scheme in setting allowances. In future, we will treat both 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.

1.3. These costs form part of the ongoing pension costs subject to the specific sharing factor in DPCR5 and at subsequent controls, the IQI incentive regime.

Pension Protection Fund Levy

1.4. There are a number of elements to the levy, the largest is risk based. This has been seen to be the highest cost element and is dependent on the requirements of the PPF. As such, its magnitude is partly outside the control of sponsors and trustees. We will continue to monitor the actions taken to mitigate the cost of 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. We reserve the option to make adjustments on a case-by-case basis where the charge appears excessive compared to peers or there is evidence to indicate inefficiency in managing this cost.

1.5. These costs form part of the ongoing pension costs subject to the specific sharing factor in DPCR5 and at subsequent controls, the IQI incentive regime.

Stranded surplus

1.6. In the event that a surplus arises (i.e. assets exceed the full buy-out cost of accrued liabilities) it is the trustees that have the power to decide whether it is in the interests of scheme members to repay it to the employer in accordance with the scheme rules and other legal requirements. Trustees have obligations to protect scheme members, and are

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likely to use any surplus in de-risking their investment strategy. If this was the case consumers may not benefit, although they, together with scheme members and sponsors, would have contributed to it.

1.7. We will monitor each scheme's position on an annual basis. If a scheme were in surplus for a given period, we consider it is a reasonable expectation for symmetry in the treatment for funding of deficits. We would therefore expect to share the benefit across members and consumers. 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. We do not consider that reducing risk is always efficient if it leads to higher funding and deficits. Each instance will be reviewed on a case-by-case basis.

Buy-ins and buy-outs of pension schemes liabilities

1.8. These currently fall within the scope of Principles 1, 2 and 5. Buy-ins and buy-outs are effectively a de-risking of future liabilities. It is necessary to determine how such de-risking should be funded, to facilitate efficient management of the schemes and to remove uncertainty as to the regulatory treatment. It is difficult to be prescriptive as to how they should be spread between different generations of consumers. For guidance, an equitable option is to spread these costs over the same deficit repair period that is used in setting ex ante allowances. We will deal with these, if they occur, applying the existing Principles on a case-by-case basis.

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.

1.9. 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 the main price control review. In Principle this may include costs related to self-financing excluded services, distributed generation, metering, de minimis activities of the NWO and of unregulated businesses in the same scheme, de minimis business and excluded services (which are self-financing) in the context of a transportation and/ or distribution price control. 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.

1.10. At DPCR4, there was a general assumption of a 20 per cent disallowance for non-regulated activities for most licensees. For DPCR5, this split was retained as a starting point. At TPCR4, only the proportion of ongoing contributions and existing deficit that related to unregulated activities was disallowed. In GDPCR1, a small adjustment was made in respect of pensions relating to the metering business.

1.11. The regulatory fraction determined in setting allowances will be reviewed to assess the ex post adjustment when there have been structural changes to a scheme, at each full valuation within a price control period and for setting ex ante allowances at each price control. We will also review and adjust for movements, including cash funding by sponsors to the previously unfunded ERDCs.

1.12. Structural changes may occur when:

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- schemes merge or demerge,
- members are transferred in or out in bulk,
- there is a change of ultimate controller, and
- there is a buy-in/buy-out of any part of the scheme membership.

1.13. The non-regulated component of pension liabilities should logically reduce over time in a closed pension scheme for a predominantly wires or pipes only business. Thus, the allowed regulated fraction should increase. This will be calculated by determining the liabilities attributed to the active scheme members in the regulated business and the movement from the position determined at the previous price control. For DNOs this will over time, move the fraction to their actual attribution (where supported by the necessary records) from the 80:20 pragmatic split at DPCR4. The methodology is set out in **Chapter 10 of the Financial Methodologies document (ref 148/09)**. This element of the regulatory fractions is only reset at the start of each price control period for setting ex ante allowances. It does not apply in the calculation of any ex post adjustment. This mechanism is not applicable in gas distribution networks as their schemes only had active members transferred from NGGT.

1.14. We expect NWOs to maintain appropriate records to enable this assessment. In the absence of detailed records, we will apply our own judgement. We will revise the allowed proportion and apply it within a price control period for computing the ex post adjustments and updating RAV where deficits are part of additions to RAV.

1.15. We will review each occurrence on its merits and would expect companies to approach us at an early stage to discuss the possible impact on their ex post adjustments. We will not specifically require an actuarial assessment and valuation at each trigger point above to determine the revised allowed proportion, as we recognise that it is not necessarily cost effective for NWOs to have an annual actuarial assessment of this split. If one exists, we will use it to inform the assessment.

1.16. The regulatory fraction will be reviewed at each subsequent price control using the basis in the previous control as a starting point and allowing for structural changes as set out above. For example, in DPCR5 this would be the 80/20 split adopted for most companies at DPCR4. For gas distribution and the electricity and gas transmission schemes the basis at TPCR4 and GDPCR1 will continue, subject to review, and the effects arising from structural changes and bulk transfers.

Bulk transfers

1.17. During a price control period there may be bulk transfers of members in or out of a DB scheme through corporate activity. These transfers are usually only accepted when the transfer value finances the deficit, if any, of the transferees. Bulk transfers in to a scheme have to be approved by trustees and as specified by the Pension Regulator, have to be fully funded (in all but exceptional circumstances). TPR guidance states: "There is no statutory obligation for a trust-based scheme to accept transfers-in and provide benefits in exchange. Some schemes do offer defined benefit transfer credits, typically in the form of 'added years' counting for benefits on the scheme's normal formula. Other schemes offer money purchase benefits in exchange for transfers, in which case no issues arise as to assumptions for determining benefits"; and that, "A transfer credit should not be expected to require additional funding from the employer in the long term unless agreed by the employer in advance." Under the Protected Person's legislation, a scheme has to accept a transfer of a protected person. We consider that movements in deficits arising from bulk transfers that result from corporate transactions, whether fully funded or not, should be a risk for shareholders and not consumers. This applies even where the transferred protected person's pension liability is underfunded where it arises from a corporate transaction.

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1.18. Whilst transfers in may be accepted and some may include protected persons who may or may not be considered part of the regulated activities, it is considered that in order to control future deficits that shareholders, not consumers should fund any increase related to the transferees at future price controls.

1.19. This clarification covers only bulk transfers where individuals or groups of individuals (but not whole, or, substantially whole schemes) are transferred as part of a smaller transaction to acquire an activity rather than a licensee. A full merger between two existing DB schemes as a result of a corporate transaction is therefore excluded and will be dealt as a structural change (see above).

1.20. We cannot predict whether this treatment will be equitable to all situations. If we are satisfied that there are exceptional circumstances, we retain the option to deal with these on a case-by-case basis.

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.

1.21. 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, though, since the pensions Principles were established, the Pensions Act 2004 introduced a requirement that trustees should have knowledge and understanding of the law of trusts and pensions and Principles of funding and investment. This should mean it is less likely that we will encounter poor stewardship issues. We will review stewardship and reserve our position to make adjustments to allowances if we observe, for example, 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 been 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 which do not match future liabilities,
- accepting transfers in at under value, and
- making transfers out at over value.

1.22. In determining whether pension costs are reasonable, we may 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, subject to any incentivisation adjustment and an efficiency review. This is one indicator of whether there has been a material failure in stewardship. We will also examine investment and administration costs to see whether these are materially out of line with industry figures.

1.23. It is recognised 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. These 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

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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.

1.24. 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. We would expect and may request that, where the timing of valuations does not align with price control periods, companies obtain updated valuations as close as possible to the end of the price control as is practical given the timing of setting the Final Proposals.

1.25. 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 an increase in funding required we may adjust the recommended funding rate for the purposes of setting the price control.

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 were estimated on a case-by-case basis.

1.26. Typically, actuarial valuations of pension funds are carried out triennially. In contrast, price controls are typically set for periods of five years, following the outcome of the RPI-X@20 review this may be longer. Accordingly, it is possible that funding rates will change during the period of a price control. In practice with scheme-specific funding and the Pension Act 2004 requirement for annual valuations it is possible that individual or scheme specific events may bring forward valuation dates.

1.27. In our decision for DPCR5 and subsequent reviews, we have introduced a trigger mechanism, being an independent efficiency review, for clarifying how and when we may either true up to actual cash costs or subject them to a review to assess the quantum of costs that we would true up ex post. We also stated that funding of any incremental deficit in excess of the established deficit at the end of the DPCR5, TPCR4 and GDPCR1 price controls would be subject to the same incentive mechanism as all other costs (including ongoing pension service costs). At present, this is generally the information quality incentive as calibrated for individual price controls. In principle we will apply the following guidelines, which are mainly but not exclusively applicable to the open price controls- DPCR5, TPCR4 and GDPCR1:

1. We will log up the cumulative effect and pass the impact through to consumers when setting the price control at subsequent reviews subject to determining that such costs comply with Principle One being both economic and efficient and subject to any incentive mechanism applicable at a particular control.
2. In assessing the quantum, adjustments may be made where the costs are not determined to be both economic and efficient in line with Principle One.

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3. Subject to any applicable incentive mechanism, we will reflect differences (if any) between the allowances made in setting previous price controls and the actual employer contributions made to pension funds over the same period.
4. To the extent that actual contributions in any period fall short of or exceed the assumed contribution, these will be dealt with in accordance with the appropriate incentive mechanism.
5. Where 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, this will be reviewed to ensure that the interests of consumers are not being compromised.
6. If we think that the level of funding has the impact of penalising current consumers, albeit that this may 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.
7. Subject to any applicable incentive mechanism, 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 Two (Attributable Regulated Fraction).
8. Subject to any applicable incentive mechanism, 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. This does not apply to DPCR5, because there are specific sharing factors.
9. Subject to any applicable incentive mechanism, the difference between the ex ante allowances for pension administration costs and the PPF levy and the actual cash funding costs will be adjusted at the next price control. This will be subject to NWOs demonstrating that the costs are economic and efficient, e.g. that steps have been taken to mitigate, in particular, the risk-based element of the PPF levy and are comparable with appropriate comparators.
10. As noted under Principle Two, we will apply a revised regulatory fraction where there have been structural changes to a scheme in the price control period on a case-by-case basis. The element of the fraction related to movements in unfunded ERDCs will only be changed at a subsequent price control, except where through structural changes it can be clearly demonstrated that they have been fully funded.
11. Subject to any applicable incentive mechanism, increases in pension costs against allowances will therefore in general be recoverable from (or decreases recaptured for) consumers on an NPV-neutral basis.

Unexpected lump sum deficit payments

1.28. These tend to occur in instances of change in corporate control, or through corporate activity within the NWO's wider group. 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.

1.29. We will 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

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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 notional deficit recovery plan.

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.

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

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

1.32. 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 *following methodology*:

- At each control, companies will have supplied details of amounts relating to ERDCs. An adjustment is made to the Regulatory Fraction to reduce the deficit funding. Meaning the shareholders would in effect need to make good the shortfall.
- These unfunded ERDCs theoretically still exist at the next control in most cases. We accept that, where schemes have subsequently been taken over and scheme deficits paid off at that time this will also include the ERDCs.
- To derive the movements and obtain an updated position at the next control:
 - We take the position at the last control, rebased using RPI to real prices.
 - An adjustment is then made for companies where the scheme deficit has been cleared, by for example a take-over and subsequent funding in total of the deficit.
- This revised sum is then rolled forward each year to create a closing forecast position at the end of the last price control by:
 - adding expected returns (using the cost of capital for that control).
 - deducting the proportion of the deficit payments that were disallowed in that control. The expected return is used (rather than actual returns) since this is the figure on which the original valuation was based.
- The resulting forecast values of ERDCs at the end of the control period are compared to the deficits that are being forecast at the end of the control and a percentage is calculated. This is then used to reduce the regulatory fraction.

Example:

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ERDC reduction calculation					
	2005/06	2006/07	2007/08	2008/09	2009/10
B fwd	25.0	23.4	22.0	20.4	18.6
Return at cost of capital	1.4	1.3	1.2	1.1	1.0
Deficit Payments (ERDC fraction)	(3.0)	(2.7)	(2.9)	(2.9)	(2.9)
C fwd	23.4	22.0	20.4	18.6	16.8
Deficit Payments (distribution element)	(20.0)	(18.0)	(19.0)	(19.0)	(19.0)
% of deficit reduced for ERDCs in DPCR4	15%				

Appendix 2: Additional background reference material

- [Price Control Pension Principles – Ofgem Consultation Document 120/08 – 7 August 2008](http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=98&refer=Networks/ElecDist/PriceCntrls/DPCR5)
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=98&refer=Networks/ElecDist/PriceCntrls/DPCR5>
- [Open letter to network operators 17 December 2008 – Price Control Principles Questionnaire](http://www.ofgem.gov.uk/Networks/Documents1/Pensionper cent20questionnaireper cent20coveringper cent20letter.pdf)
<http://www.ofgem.gov.uk/Networks/Documents1/Pensionper cent20questionnaireper cent20coveringper cent20letter.pdf>
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