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

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Dear colleagues

Resetting pension deficit funding allowances and our reasonableness review

The price controlled gas and electricity transmission and distribution network operators (NWOs) are obliged to fund defined benefit pension schemes. These existed at the time of privatisation. They are now all closed to new members, although some active members remain. The schemes have substantial liabilities to pay future pensions and have accumulated substantial financial investments to pay them. However, because people live longer and financial markets are not expected to perform as strongly as expected in the past, the schemes have been in deficit for much of the last decade. Our policy is that these legacy obligations are funded in NWOs' regulated revenues.

We have an established approach for reviewing and resetting pension deficit funding allowances. We outlined our approach in our 22 June 2010 decision document 'Price Control Treatment of Network Operator Pension Costs Under Regulatory Principles' and we have clarified our approach in subsequent price control documents.[1]

We reset allowances for pension deficit funding every three years, following triennial actuarial valuations of the relevant pension schemes. These valuations are carried out on behalf of pension scheme trustees. We review the reasonableness of these valuations and, subject to any adjustments that arise, calculate the new deficit funding allowances. These include adjustments to true-up for any differences between allowances and amounts actually funded by the NWOs.

For RIIO-ED1, we will include the new pensions deficit funding allowances in the companies' opening base revenues. We refer to this in our RIIO-ED1 slow track final determinations, also published today. For fast track DNOs, the new allowances will be effected through our fast track update process. For NWOs regulated under RIIO-T1 and GD1, they will be effected through our annual iteration process. We are publishing the results of this process today for all NWOs other than SHE Transmission.

Reasonableness review

Following consultation, we appointed the Government Actuary's Department (GAD) to review the pension schemes' valuations. In our October 2013 consultation letter, we said we would expect to provide funding for established deficits unless we identify:

[1] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=119&refer=Networks and subsequent final proposal documents for gas distribution (RIIO-GD1), gas and electricity transmission (TPCR4R and RIIO-T1) and the RIIO-ED1 Strategy Decision document (see appendix 4 for links)

- significant differences in the governance of a company's pension scheme relative to broader comparators inside and outside the sector
- those differences are to the detriment to consumers, taking today's consumers together with tomorrow's consumers and appropriate criteria for evaluating both risk and inter-generational issues
- those differences are reasonably attributable to the NWO, recognising the responsibilities and independence of trustees.

Our terms of reference for the GAD's review were designed to help us assess these points. We focused on valuation assumptions, member benefits, scheme governance, investment strategies and risk management.

We have studied the GAD's report and discussed its findings with the actuary who carried out the work. While the report highlights differences between schemes, these do not justify not funding any of the established deficits. This view extends to possible adjustments to allowances identified following our last review which we said we would consider further during this review. We do not intend to carry out a second stage (more detailed) review of any issues identified.

The possible adjustments we identified following our last review were in part about how NWOs can limit pension increases if RPI exceeds 5%. For some schemes, depending on their rules, the relevant RPI did exceed 5% in 2012. We are satisfied that NWOs made representations to trustees to limit increases where they could. The other possible adjustments involved differences in the timing of deficit repair payments. These are effectively resolved through our trueing-up adjustments.

Calculation of new deficit funding allowances

We have calculated new deficit funding allowances in accordance with the relevant handbooks or the allowance-setting process in ED1.

We first quantify the established deficit, which takes account of the portion of the overall pension scheme attributable to the regulated business and to service before the cut-off dates we have specified for each sector. These are 31 March 2010 for electricity distribution, 31 March 2012 for electricity and gas transmission and 31 March 2013 for gas distribution.

We then identify the cumulative difference between deficit funding allowances and the amounts companies have actually paid for the established deficits. These amounts are annuitised and spread over the remaining years of the 15-year funding period.

We are encouraged that National Grid have negotiated lower levels of deficit repair payments with trustees than would be calculated using this funding methodology. We have modified their deficit funding allowances accordingly.

The results of these calculations for each sector are set out in the following tables.

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Gas Distribution *(£m 2009/10)*

	RIIO-GD1 base revenue allowances	*Established deficit at 31 March 2013*	*Annualised*	*True-up to actuals***	*New allowances from 2015/16*	*Movement*
East	4.4	73.4	* 3.7	(0.2)	3.5	(0.9)
London	3.0	50.2	* 2.5	(0.1)	2.4	(0.6)
North West	3.3	55.9	* 2.8	(0.1)	2.7	(0.6)
West Midlands	2.4	40.3	* 2.0	(0.1)	1.9	(0.5)
Northern	6.7	80.2	7.0	0.0	7.0	0.3
Scotland	6.8	66.4	5.8	0.1	5.9	(0.9)
Southern	10.2	100.0	8.7	0.2	8.9	(1.3)
Wales & West	7.0	82.1	7.1	0.2	7.2	0.2
Total	**43.8**	**547.6**	**39.6**	**0.0**	**39.5**	**(4.3)**

** NWOs in National Grid have negotiated reduced deficit funding levels*
*** This trues-up the actual deficit repair payments since the beginning of the price control to actuals and annuitises the difference over the remaining years of the 15-year funding period.*

Transmission *(£m 2009/10)*

	RIIO-T1 base revenue allowances	*Established deficit at 31 March 2013*	*Annualised*	*True-up to actuals***	*New allowances from 2015/16*	*Movement*
NGET TO	28.9	595.2	* 32.8	(0.3)	32.6	3.7
NGET SO	8.8	180.8	* 10.0	(0.1)	9.9	1.1
NGG TO	25.8	905.0	* 49.3	0.1	49.4	23.6
NGG SO	0.2	15.0	* 0.8	0.0	0.8	0.6
SPTL	0.2	21.1	2.0	0.2	2.1	1.9
Total	**64.4**	**1,734.8**	**96.1**	**0.1**	**96.3**	**31.9**

** NWOs in National Grid have negotiated reduced deficit funding levels*
*** This trues-up the actual deficit repair payments since the beginning of the price control to actuals and annuitises the difference over the remaining years of the 15-year funding period.*

Electricity Distribution *(£m 2012/13)*

	DPCR5 annual allowances	*Established deficit at 31 March 2013*	*Annualised*	*True-up to actuals**	*New allowances from 2015/16*	*Movement*
ENWL	17.3	181.6	17.0	(1.2)	15.8	(1.5)
NPgN	18.2	152.9	14.3	0.1	14.4	(3.8)
NPgY	8.7	73.2	6.9	0.0	6.9	(1.8)
WMID	19.4	299.8	28.1	4.5	32.6	13.2
EMID	17.9	293.2	27.5	4.4	31.9	14.1
SWALES	13.2	255.9	24.0	1.5	25.4	12.2
SWEST	23.4	388.3	36.4	1.7	38.1	14.7
LPN	29.2	372.5	34.9	4.9	39.8	10.6
SPN	24.0	312.1	29.2	4.8	34.1	10.0
EPN	8.4	128.6	12.0	3.2	15.3	6.9
SPD	8.9	269.5	25.2	2.9	28.1	19.2
SPMW	16.3	255.1	23.9	3.8	27.7	11.4
SSEH	13.8	118.1	11.1	1.8	12.9	(0.9)
SSES	34.3	337.6	31.6	0.6	32.2	(2.1)
Total	**253.0**	**3,438.3**	**321.9**	**33.0**	**355.0**	**102.0**

*Trues-up actual payments to allowance through the whole of DPCR5 and annuitises the difference over the remaining years of the 15-year funding period

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The focus of future reviews

Benefits

In developing our approach to this review, we recognised that pension schemes are governed by boards of trustees who are responsible to scheme members rather than NWOs. Pension schemes are subject to regulation by the Pensions Regulator.

We also recognise that how much of a deficit is funded in a period does not alter the overall burden of the deficit.

We believe our concern on behalf of consumers should therefore be more about the overall burden of a deficit than about how quickly it is funded. Although trustees, not NWOs, are responsible for pension scheme governance, NWOs are in a position to manage the benefits accruing to the remaining active members.

There are significant historical protections for members of these schemes, as is the case with many other regulated industries. These make it difficult to change the benefits. However, the benefits provided by these schemes are generous compared to some other pension schemes, both public and private.

Pension benefits are part of a broader package of benefits, and we believe there would be scope to make changes that are positive both for members (modernising schemes, providing additional options and flexibility) and for consumers (constraining the cost of established deficits). Some NWOs, and companies in other regulated sectors, have made or are pursuing more innovative approaches to benefits. Communication with members to understand their needs and preferences would be important in developing a package of benefits that work for companies, consumers and members.

Over the next three years, before our next review, we will expect NWOs to demonstrate that they are doing their best to ensure that benefits are reasonable and comparable to market benchmarks. In our next review, we envisage considering and comparing what has been achieved by other NWOs, other regulated sectors and the wider private sector. We would also look to NWOs to explain to stakeholders how they are managing pension scheme benefits in the interest of consumers.

Administration expenses

We agree with the GAD's assertion that administration expenses should be considered in the next reasonableness review. While these expenses are a small portion of the overall cost of providing pensions, NWOs can influence them, so in the next review we will consider them more closely.

Alternative funding arrangements

Alternative funding proposals are becoming more popular, as they offer certainty to trustees and flexibility to sponsors. Options such as escrow, charge over assets and surety bonds can give trustees the comfort of knowing the funds will be available if required, while making sure consumers are not over-funding pension schemes.

Our regulatory arrangements should give trustees confidence that funds will be available when required. We encourage companies and trustees to consider how any alternative funding proposals would benefit consumers.

De-risking

The GAD's report shows that most schemes have moved to smaller allocations to return-seeking assets. Some are pursuing more extensive or complex strategies to reduce risk, including hedging. The GAD notes that this is consistent with the broader market experience.

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We do not in principle object to progressive de-risking. However, as we note above, our regulatory arrangements should give trustees confidence that funds will be available when required, irrespective of risk. Companies and trustees should consider how risk management would benefit consumers.

Future evolution of pension scheme governance and funding

In the past we have indicated our commitment to funding established deficits over a 15-year period from the relevant cut-off dates for each sector. In our decision outlining this commitment we noted that this 15-year period allows time for uncertainty to reduce. The timing may need to be reviewed or reset depending on circumstances.

For now, the economic uncertainty surrounding pension deficits continues, particularly the low level of interest rates. As the end of this funding period approaches, pressure may increase on trustees and NWOs to fund deficits with increasingly prudent assumptions to ensure the established deficit is fully funded. We wish to avoid perverse incentives that might harm consumers.

To manage this uncertainty and to normalise the pressure on trustees and NWOs we plan to consult early next year on our approach to pension deficit funding.

We will continue to ensure that deficit funding allowances are reasonable through our triennial pensions reasonableness reviews. We will continue to focus on consumer interests. Our object is to ensure NWOs reflect the interest of consumers during their discussions with trustees.

We recognise the legal obligations of trustees, and their primary duties towards pension scheme members. We plan to work with the Pensions Regulator to develop guidance for trustees where deficits are funded in full or in part by our deficit funding allowances.

Yours faithfully

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