

## Chapter 3: Pension Scheme Established Deficit revenue allowances - financial adjustment methodology

### Section 1 - Introduction

3.1 The Opening Base Revenue Allowances for the licensee, specified in the box below, include allowances for Pension Scheme Established Deficit (PSED) repair expenditure for each Regulatory Year of the Price Control Period.<sup>1</sup> For all price controls other than RIIO-ED1, they also include Pension Scheme Administration and Pension Protection Fund levy expenditure for each Regulatory Year of the Price Control Period.<sup>2</sup>

<i>Price control</i>	<i>Opening Base Revenue Allowances</i>	<i>Set out in the table appended to:</i>
RIIO-GT1	PU and SOPS values	Special Conditions 2A (Restriction of NTS Transportation Owner Revenue), and 3A (Restriction of NTS System Operation Revenue)
RIIO-GD1	PU values	Appendix 1 to Special Condition 1B (Restriction of revenue in respect of the Distribution Network Transportation Activity)
RIIO-ET1	PU and, for NGET, SOPS values	Appendix 1 to Special Condition 3A (Restriction of Transmission Network Revenue) and, for NGET, Appendix 1 to Special Condition 4A (Restriction on System Operator Internal Revenue)
RIIO-ED1	PU values	Appendix 1 to CRC 2A (Restriction of Allowed Distribution Network Revenue)

3.2 These allowances are represented by the opening Pensions Allowance values, specified in the box below, held in the Price Control Financial Model (PCFM) Variable Values Table for the licensee contained in the PCFM specified in the box below and are expressed in the price base specified in the box below. Opening Pensions Allowance values are based on modelling assumptions and parameters applicable at the outset of the Price Control Period.

<i>Price control</i>	<i>Pensions Allowance values</i>	<i>Opening values as at</i>	<i>PCFM</i>	<i>Price base used</i>
RIIO-GT1	EDE, APFE, SOEDE and SOAPFE values	1 April 2013	GT1 Price Control Financial Model	2009-10 prices
RIIO-GD1	EDE and APFE values	1 April 2013	GD1 Price Control Financial Model	2009-10 prices
RIIO-ET1	EDE, APFE, SOEDE and SOAPFE values	1 April 2013	ET1 Price Control Financial Model	2009-10 prices

<sup>1</sup>Ongoing Pension Service Costs are included as an element of labour costs and are outside the scope of this chapter.

<sup>2</sup> For RIIO-ED1, ongoing Pension Service Costs included as an element of labour costs also include pension scheme administration and Pension Protection Fund levy costs.

<i>Price control</i>	<i>Pensions Allowance values</i>	<i>Opening values as at</i>	<i>PCFM</i>	<i>Price base used</i>
RIIO-ED1	Pensions Allowance values	1 April 2015	ED1 Price Control Financial Model	2012-13 prices

The allowance levels will be updated during the Price Control Period by revising Pensions Allowance values (specified in the box in paragraph 3.2) for the purpose of the Annual Iteration Process for the PCFM. This chapter sets out:

- the reasons for updating allowances
- the methodologies for determining revised Pensions Allowance values
- the expected timing of revisions, and
- the effect on the licensee’s allowed revenue of revising Pensions Allowance values for the Annual Iteration Process.

3.3 In the context of Pension Scheme Established Deficit repair expenditure we refer to ‘allowances’ rather than ‘allowed expenditure’. This is because Pensions Allowance values are included in full in recalculated base revenue figures in the PCFM under the Annual Iteration Process.

3.4 The Price Control Period ends on the dates set out in the box below, but Pensions Allowance values will be determined having regard to further PSED repair periods determined under the methodology set out in this chapter.

<i>Price control</i>	<i>Start of control period</i>	<i>End of control period</i>
RIIO-GT1	1 April 2013	31 March 2021
RIIO-GD1	1 April 2013	31 March 2021
RIIO-ET1	1 April 2013	31 March 2021
RIIO-ED1	1 April 2015	31 March 2023

#### *Price control pension principles*

3.5 The Authority’s price control pension principles are set out in our guidance note on price control pension principles under RIIO issued as Appendix 3 to the decision letter, ‘Decision on the Authority’s policy for funding Pension Scheme Established Deficits’ dated 7 April 2017.

## Section 2 – General provisions

### *Pension Scheme Established Deficit*

3.6 For the purposes of the financial adjustments conditions specified in the box below and this chapter,

- (a) The term cut-off date refers to the date specified in the box below
- (b) the term Pension Scheme Established Deficit (PSED), or “established deficit”, means an amount derived as the value of the liabilities within a defined benefit pension scheme (or schemes) sponsored by the licensee

expressed as a positive number, less the corresponding assets, where those assets and liabilities are:

- attributable to the licensee's regulated business specified in the box below, and
  - attributable to pensionable service up to and including the cut-off date.
- (c) The proportion of any wider group pension scheme deficit which is attributable to the licensee's regulated business and to pensionable service up to and including the cut-off date will be determined in accordance with the pension deficit allocation methodology published by the Authority.

<i>Price control</i>	<i>Financial adjustments conditions</i>	<i>Licensee's regulated business</i>	<i>Cut-off date</i>
RIIO-GT1	Special Condition 5C (Specified financial adjustments – NTS Transportation Owner), 6c (Specified financial adjustments – NTS System Operator)	Transportation business	31 March 2012
RIIO-GD1	Special Condition 3C (Specified financial adjustments)	Transportation business	31 March 2013
RIIO-ET1	Special Condition 6D (Specified financial adjustments – Transmission Owner), 7C (Specified financial adjustments – System Operator)	Transmission business	31 March 2012
RIIO-ED1	CRC 3C (Specified financial adjustments)	Distribution business	31 March 2010

3.7 Where relevant, the PSED is further divided into parts of the licensee's regulated business specified in the box below accordance with the Authority's pension deficit allocation methodology.

<i>Price control</i>	<i>Split between</i>
RIIO-GT1	Transportation Owner (TO) and System Operator (SO)
RIIO-GD1	Not relevant
RIIO-ET1	For NGET, Transmission Operator (TO) and System Operator (SO)
RIIO-ED1	Not relevant

3.8 The definition set out in paragraph 3.6(b) applies even if the value derived is a negative amount (a surplus position) and may be described as an "established surplus".

3.9 On a triennial basis (see Table 3.1) the licensee provides the Authority with:

- a Scheme Valuation Data Set comprised of:
  - the actuarial valuation of each defined-benefit scheme in respect of which the licensee is a sponsoring employer, being either a full valuation or an update of the last preceding full triennial valuation, with the asset and liability values projected forward to the full valuation date on the basis set out in the Pension Deficit Allocation Methodology

- each scheme's statement of funding principles
  - each scheme's statement of investment principles, and
  - any other information reasonably required, and subsequently,
- separate Pension Deficit Allocation Methodology tables.

3.10 The licensee's PSED will be determined using:

- (a) the triennial actuarial valuation of the pension scheme or schemes that contain the PSED described in paragraph 3.6(b)
- (b) the allocation of assets and liabilities in the scheme(s) referred to in subparagraph (a) to the PSED using the Pension Deficit Allocation Methodology<sup>3</sup>; the effective date for revised allocations at each triennial actuarial valuation take effect in the year rr, and
- (c) the Reasonableness Review with respect to the price control pension principles which could, exceptionally, result in adjustments to the PSED figure on account of errors in methodology or data.

#### *Asset-backed funding arrangements*

3.11 The licensee may choose to enter into asset-backed funding arrangements with pension scheme trustees, either directly or indirectly through related parties. Such arrangements might include a range of alternative funding arrangements, for example, mechanisms involving contingent assets or loan notes benefitting relevant pension schemes.

3.12 Any asset-backed funding arrangements must be fully compliant with all conditions, for example relating to the ring fence, in the licensee's licence (except where appropriate consent has been granted under the terms of a condition).

3.13 Notwithstanding that an arrangement may be fully compliant with licence conditions, the licensee is encouraged to provide information on any such mechanism or prospective mechanism to the Authority at the earliest opportunity. In general, the Authority would encourage asset-backed funding arrangements that would facilitate the return of funds to consumers in the event that a pension scheme deficit turns out to be smaller than anticipated.

3.14 Asset-backed funding arrangements would in general be disregarded in the determination of revised Pensions Allowance values because allowances are provided for PSED repair and not to fund ancillary arrangements per se. However, such arrangements would be relevant in any proposal by the licensee for Pensions Allowance values under the methodology set out in Section 3 of this chapter.

#### *Pension Scheme Administration and PPF levy*

3.15 Where relevant, for the purpose of the conditions specified in the box below and this chapter, Pension Scheme Administration means the range of activities that pension scheme trustees are required by legislation to undertake or commission in running the pension scheme. It includes, without limitation, the keeping of scheme records, scheme management and administration, scheme policy and strategy, the provision of information to scheme members, the calculation and payment of benefits and liaison with tax and

<sup>3</sup>Energy Network Operators' Price Control Pen

regulatory authorities, and the preparation of valuations. It does not include investment management fees which are remunerated by deduction from investment returns or costs which are the responsibility of the licensee, such as the costs of advisors to the licensee on managing or advising it on any and all aspects of the its relationship with the trustees including recovery plans.

<i>Price control</i>	<i>Relevant licence conditions</i>
RIIO-GT1	Special Conditions 5C and 6C
RIIO-GD1	Special Condition 3C
RIIO-ET1	Special Conditions 6D and 7C
RIIO-ED1	Not relevant

3.16 Pension scheme administration expenditure refers to payments made by the licensee to cover the proportion of Scheme Administration Costs attributable to the licensee's regulated business.

3.17 Where relevant, these two items are apportioned between the parts of the licensee's regulated business specified in the box below paragraph 3.7.

## Costs and adjustments outside the scope of this chapter

### *Pension costs for service after the cut-off date*

3.18 The following costs are dealt with as Totex expenditure in the relevant price control and therefore fall outside the scope of this chapter:

- (a) pension costs associated with employee service after the cut-off date
- (b) accrued liability costs associated with employee service after the cut-off date (Pension Scheme Incremental Deficit costs), and
- (c) For licensees subject to RIIO-ED1, pension scheme administration costs and Pension Protection Fund levy costs.

### *Legacy true-up for ongoing pension service cost payments made by a relevant licensee during the DPCR5 Price Control*

3.19 Under the terms of the price control that preceded the RIIO-ED1 Price Control Period (the DPCR5 Price Control), a relevant licensee is entitled to a true-up amount derived using the difference between the level of ongoing pension costs included in its DPCR5 Revenue Allowances and the actual payments made by the licensee to the pension scheme relating to:

- (d) the funding of defined benefit pension schemes in respect of pensionable service that took place on or after 1 April 2010
- (e) the funding of defined contribution schemes and Personal Accounts associated with Qualifying Workplace Pension Schemes under the provisions of the Pensions Act 2008, and
- (f) pension administration costs.

3.20 Where relevant, any outstanding adjustment in respect of the true-up described in paragraph 3.19, in relation to outturn expenditure levels for Regulatory years 2013-14 and 2014-15, not taken into account in the calculation of the licensee's Opening Base Revenue

Allowances, will be applied in accordance with the DPCR5 Pension adjustment set out in chapter 15 section 2(i) of this handbook.

*True-up for pension payments by a relevant licensee in the GDPCR1 price control period*

3.21 For the price control period preceding RIIO-GD1 (the GDPCR1 price control), a true-up was applied to the difference between the level of pension costs included in the licensee's allowed revenues, and the actual payments made by the licensee to the pension scheme.

## Section 3 – Methodology for revising Pensions Allowance values

### Overview

3.22 The licensee's Pensions Allowance values may be revised during the Price Control Period to reflect:

- (a) information contained in pension scheme actuarial valuation reports provided by the licensee to the Authority
- (b) the licensee's updated PSED (defined in paragraph 3.6)
- (c) information on the history of actual amounts received by the relevant pension scheme(s) in respect of PSED repair payments, attributable to the licensee, contained in price control review information submitted to the Authority
- (d) where relevant, pension scheme administration and PPF levy costs information contained in the licensee's price control review information submitted to the Authority
- (e) proposals made by the licensee for Base Annual PSED Allowances and payment history allowances
- (f) asset-backed funding arrangements associated with proposals referred to in subparagraph (e)
- (g) the outcomes of Reasonableness Reviews (see paragraph 3.58) and
- (h) and any pension contribution holiday attributable in whole or in part to the existence of an established surplus.

3.23 The licence conditions relevant to this section specified in the box below requires the Authority to determine annually whether any Pensions Allowance values should be revised. However, the intention is that the values will only be revised periodically in light of triennial actuarial valuations of the relevant pensions schemes. The timetable for these is set out in Table 3.1 below. The timetable for the Authority's determination of revised Pensions Allowance values, following Reasonableness Reviews, is set out in Table 3.2. It may, however, be necessary to revise Pensions Allowance values at different times if, for example:

- (a) a scheme valuation is delayed, or
- (b) the completion of a Reasonableness Review (see paragraph 3.58) has been delayed.

<i>Price control</i>	<i>Relevant licence conditions</i>
RIIO-GT1	Special Conditions 5C and 6C
RIIO-GD1	Special Condition 3C
RIIO-ET1	Special Conditions 6D and 7C
RIIO-ED1	CRC 3C

3.24 For the avoidance of doubt, the revision of Pensions Allowance values at a different time because of the delayed completion of a Reasonableness Review will not prevent the revision of Pensions Allowance values on the two occasions referred to in paragraph 3.23 with respect to adjustments that can be taken into account at those times.

**Table 3.1 - Expected timetable for Pensions Allowance value revisions**

Pension scheme valuation date	Submission of Scheme Valuation Data Set	Pension Deficit Allocation Methodology information provided	Completion of Reasonableness Review	Direction of revised Pensions Allowance values see note
31 March 2016	7 July 2017	31 August 2017	31 October 2017 (rr = 2017/18)	30 November 2017
31 March 2019	7 July 2020	31 August 2020	31 October 2020 (rr = 2020/21)	30 November 2020
31 March 2022	7 July 2023	31 August 2023	31 October 2023 (rr = 2023/24)	30 November 2023

Note: Information relating to the defined benefit pension scheme valuation prior to the end of a control period may be taken into account in the setting of opening Pensions Allowance values for the subsequent price control. This table specifies the expected timetable, but some dates may be subject to variation as governed in Table 3.2.

3.25 Licensees whose scheme triennial valuation dates differ to those shown in the first column of Table 3.1 will be required to provide either a full valuation or an updated valuation as at these dates. The approach that should be used by the licensee to produce an updated valuation is set out in the Authority's Pension Deficit Allocation Methodology.

3.26 As stated in paragraph 3.23, the Authority will direct revised Pensions Allowance values at other times, if that is necessary to reflect any revised timetable of information availability or process completion. However, in those circumstances, Pensions Allowance values would still be determined in a way that is consistent with the procedures set out in this chapter.

#### *Determination of revised Pensions Allowance values*

3.27 Revised Pensions Allowance values directed by the Authority will be expressed in the price base referred to in paragraph 3.2. The Authority's calculations and the calculations

supporting any proposals made by the licensee should be expressed in constant price terms accordingly.

3.28 Revised Pensions Allowance values will be determined on each occasion using the process set out in Table 3.2 and explained further in paragraphs 3.29 to 3.54.

#### *Base Annual PSED Allowances*

3.29 After each triennial review, in accordance with the timetable set out in Table 3.2 below, the licensee should set out its proposal for Base Annual PSED Allowances after taking account of the following paragraphs. Base Annual PSED Allowances represent how consumers will fund the established deficit as evaluated at the last triennial review.

3.30 Accordingly, the licensee should set out its calculations of the indicative further PSED repair period, the indicative base annual PSED allowance and its proposal for Base Annual PSED Allowances as specified in the following paragraphs.

#### *Indicative further PSED repair period*

3.31 The indicative further PSED repair period represents a number of years (not necessarily a whole number) from the valuation date specified in Table 3.1 and is ascertained by taking the number of years that is the lower of:

- (a) the value  $irp$ , where  $irp$  is calculated using the following formula:

$$irp = \frac{-LN\left(1 - LN(1 + DR) \times \frac{PSED}{EBAPA}\right)}{LN(1 + DR)}$$

where:

PSED is defined in paragraph 3.6, expressed in constant price terms in accordance with paragraph 3.27

LN returns the natural logarithm of the value to which it is applied

DR is an annual real (inflation-adjusted) discount rate specified in or justified with reference to the licensee's Scheme Valuation Data Set (established in accordance with Principle 4 - see paragraph 3.5), and

EBAPA is an average of the Base Annual PSED Allowance expressed in constant price terms in accordance with paragraph 3.27 for years  $rr-1$  and  $rr$ , where the year  $rr$  is the regulatory year specified in Table 3.1 for the relevant Reasonableness Review.

and

- (b) 15.

In the event that the PSED is negative,  $irp$  is set to zero.

3.32 For example, if the discount rate was 2%, the PSED was £1m and the EBAPA value was £100k, then the Indicative further PSED repair period would be 11.14 years, being the lower of:

- (a) 11.14, calculated under the formula at paragraph 3.31(a), and  
(b) 15.



### Indicative Base Annual PSED Allowance

3.33 The indicative amount for the Base Annual PSED Allowance, IBAPA, is zero if PSED is negative but is otherwise ascertained using the following formula:

$$IBAPA = PSED \frac{LN(1 + DR)}{1 - (1 + DR)^{-irp}}$$

where:

irp is the indicative further PSED repair period ascertained under paragraph 3.31, and

3.34 For example, if the PSED was £1m in 2012/13 prices, the Indicative further PSED repair period was 11.14 years, and the discount rate was 2%, the indicative Base Annual PSED Allowance would be £100k. IBAPA will equal EBAPA unless irp is limited to 15.

### Proposal for Base Annual PSED Allowances

3.35 Subject to its consideration of the factors set out in subparagraphs (a) to (d) below, the licensee may propose allowances in line with the Indicative Base Annual PSED Allowance calculated under paragraph 3.33. The licensee should propose, with its supporting rationale, an alternative profile of Base Annual PSED Allowances over a repair period that may be shorter or longer than the period determined by paragraph 3.31 if it considers that the indicative Base Annual PSED Allowance calculated by paragraph 3.33 above either:

- (a) does not fairly represent a profile of repair payments that can be agreed with the scheme trustees,
- (b) following consultation with the Authority, does not appropriately protect the interests of consumers,
- (c) derives from an indicative further PSED repair period ascertained under paragraph 3.31 which is less than 5 years, or
- (d) is otherwise inappropriate or inequitable.

3.36 The alternative proposal under paragraph 3.35 should represent a profile of Base Annual PSED Allowances,  $PBAPA_y$  for each year  $y$  subsequent to the valuation date specified in Table 3.1, such that

$$\sum_{y \geq rr-1} \frac{PBAPA_y(1 + f \cdot DR)}{(1 + DR)^{y+2-rr}} \leq PSED + LO - ABV$$

where:

$$f = \frac{1}{LN(1 + DR)} - \frac{1}{DR}$$

LO means the value of any assets included in the PSED valuation that represent an obligation from the licensee for future payments (or other consideration) to the relevant scheme(s) under an arrangement agreed between the licensee and the scheme(s)

ABV means the value of assets as at the PSED valuation date held under asset-backed arrangements that is fairly attributable to funding by the licensee out of negative cumulative payment history variances (see paragraph 3.38) up to the valuation date and where those assets are available under an agreement with

pension scheme trustees only for future funding of an established deficit or for recovery on behalf of consumers, for example in the event that pension surpluses arise. Where relevant, the value should be determined using a methodology for the evaluation of ABV and ABC (see paragraph 3.41) agreed in writing by the Authority at or close to the inception of an arrangement, the Authority giving its reasons why it considers the methodology furthers the interests of consumers. In the absence of any such agreement, the licensee may make its own estimate of the value of ABV, which would have a symmetrical effect on the calculations in paragraph 3.41.

PBAPA<sub>y</sub> for years rr-1 and rr are the Base Annual PSED Allowances determined by the Authority for those years, and

“.” is a symbol for multiply (the mathematical operation of multiplication)

### *Payment history allowances*

3.37 The determination of revisions to Pensions Allowance values for the licensee will include payment history allowances, which may be positive or negative, relating to the cumulative variance between the licensee’s PSED repair payments and its historical allowances for PSED repair prior to the PSED valuation date. The payment history prior to a triennial valuation will affect that valuation, and thus the Base Annual PSED Allowances needed to fund it as described in paragraph 3.29. Payment history allowances ensure that customers are properly compensated if the licensee has, prior to the triennial valuation, paid less in funding the PSED than it has received from consumers, and that companies do not unduly lose out if they have paid more.

3.38 The cumulative pre-valuation payment history variance value at the end of the Reasonableness Review year,  $V_{rr}$ , is ascertained using a method permitted by paragraph 3.40 or using the following formula:

$$V_{rr} = LTU + \sum_{y=pco1}^{rr-2} \left( \frac{(D_y - E_y)(1 - CT_y)}{(1 + g_y \cdot hDR_y)(1 - CT_{rr+1})} \prod_{t=y}^{rr} (1 + hDR_t) \right) - \sum_{y=rr-1}^{rr} \left( \frac{PH_y(1 - CT_y)}{(1 + g_y \cdot hDR_y)(1 - CT_{rr+1})} \prod_{t=y}^{rr} (1 + hDR_t) \right)$$

where:

LTU is the legacy true-up value specified in paragraph 3.39, where relevant pco1 means the first regulatory year subsequent to the cut-off date

rr is the regulatory year specified in Table 3.1 for the relevant Reasonableness Review

D<sub>y</sub> means the net sum of the following, which may be positive or negative, expressed in constant price terms in accordance with paragraph 3.27:

- amounts received by the relevant pension scheme(s) in respect of PSED repair during the course of year y, for the avoidance of doubt including amounts received in respect of an obligation accounted for in the LO term in paragraph 3.36
- less any amounts directly or indirectly returned to the licensee or a related undertaking by the relevant pension scheme(s) during the course of year y under an arrangement agreed between the licensee and the scheme(s),

- less the amount by which ongoing pension contributions (for active members) have been reduced on account of an established surplus as described in paragraph 3.45.

plus any amounts determined by the Authority as pensions initiative development advisory fees following a review of evidence submitted by the licensee.

PH<sub>y</sub> is the payment history allowance determined by the Authority at a preceding reasonableness review or price control review, in accordance with row 6 of Table 3.2 or otherwise, and included in the licensee's revenue allowances for year y

E<sub>y</sub> means the licensee's Base Annual PSED Allowances plus payment history allowances, PH<sub>y</sub> (which may be positive or negative), included in revenue allowances for the year y expressed in constant price terms in accordance with paragraph 3.27. For the avoidance of doubt, E<sub>y</sub> excludes any adjustment factor value AF but includes any prior period history allowances included in revenue allowances in the period since pco1 relating to any true-up value in LTU. With the written agreement of the Authority, the licensee may adjust prior period history allowances to exclude those attributable to legacy true-up values excluded from the LTU term in accordance with paragraph 3.39.

CT<sub>y</sub> means the actual or, in the case of CT<sub>rr+1</sub>, prospective rate of Corporation Tax applicable to the licensee in year y

$\prod$  means the product of the series in the brackets for the specified range;

for example:

$$\prod_{t=rr-2}^{rr} (1 + hDR_t) = (1 + hDR_{rr-2})(1 + hDR_{rr-1})(1 + hDR_{rr})$$

hDR<sub>y</sub> means the discount rate values under any alternative discounting basis determined by the Authority in the relevant reasonableness review for year y (see row 6(f) of table 3.2) or, where no alternative discounting basis has been specified, the Vanilla Weighted Average Cost of Capital applicable to the licensee during year y

$$g_y = \frac{1}{2 + hDR_y}$$

3.39 Where relevant,

- Subject to subparagraph (b), the legacy true-up value, LTU, represents the present value as at the end of the Reasonableness Review year of any arrangement or arrangements previously agreed or determined by the Authority for the post cut-off true-up of the licensee's pension deficit payment history prior to the cut-off date or true-up of other pension-related costs.
- With the Authority's written agreement, the licensee may attribute payment history allowances to legacy true up values identified in subparagraph (a) on a present value neutral basis and exclude both attributable payment history allowances from the calculation of E<sub>y</sub> in paragraph 3.38 and the attributable LTU value from the LTU term applied in paragraph 3.38.

3.40 The licensee may choose to present a truncated calculation of the term  $V_{rr}$  specified in paragraph 3.38, on a basis that is demonstrably consistent with the formula specified in paragraph 3.38. Such a truncated calculation would include cumulative pre-valuation payment history variance values calculated for a previous reasonableness review and rolled forward for payment history variances arising since the valuation date relevant to that earlier review, discount rates and, where relevant, changes in corporation tax rates.

3.41 The licensee should propose payment history allowances for future years  $y$ ,  $PPH_y$ , such that:

$$\sum_{y \geq r+1} \left( PPH_y (1 + h_y \cdot PhDR_y) \prod_{t=r+1}^y \left( \frac{1}{1 + PhDR_t} \right) \right) \leq V_{rr} + ABC$$

$PhDR_y$  means the discount rate for payment history allowances for year  $y$  proposed by the licensee, or the rate forecast for year  $y$  according to the licensee's proposed basis of determining discount rates, in either case framed in accordance with paragraph 3.42. Such a proposal may relate  $PhDR_y$  to the value of DR, the value of WACC or rates of return on asset-backed arrangements. In the absence of any proposal,  $PhDR_y$  is  $WACC_{r+1}$ .

ABC means the deemed present value as at the end of the Reasonableness Review year of the cumulative funding of asset-backed arrangements through negative cumulative payment history variances up to the valuation date and where those assets are available under an agreement with pension scheme trustees only for future funding of an established deficit or for recovery on behalf of consumers, for example in the event that pension surpluses arise. Where relevant, the value should be determined using a methodology for the evaluation of ABV (see paragraph 3.36) and ABC agreed in writing by the Authority at or close to the inception of an arrangement, the Authority giving its reasons why it considers the methodology furthers the interests of consumers. In the absence of any such agreement, ABC should be set at the present value of ABV specified in paragraph 3.36 as at the end of the reasonableness review year, after applying appropriate discount rates (generally  $hDR_y$ ).

$$h_y = \frac{1}{2 + PhDR_y}$$

*Framing proposals for Base Annual PSED Allowances and payment history allowances*

3.42 In framing its proposals under paragraphs 3.35 and 3.41, the licensee should set out why it considers its proposals appropriately protect the interests of consumers. The licensee's explanations should, in each case where appropriate, refer to the prevailing level of Base Annual PSED Allowances, the profile of repair payments that can be agreed with the scheme trustees, how it has sought to maintain confidence of scheme trustees in the covenant with the licensee in support of such agreement, how it has sought to minimise the risk of stranded surplus, how it has sought to balance the interests of existing and future consumers, how it has sought to manage the volatility of revenues and financial ratios and any asset-backed arrangements that are intended to protect the consumer interest. The licensee's explanations should, where appropriate, refer to or be consistent with information it submitted in accordance with Table 3.2 row 3.

### *Established surpluses*

3.43 The existence of an established surplus indicates that consumers have funded the relevant pension scheme more than it would now appear was necessary. One of the objectives behind our policy is to protect the consumer interest by encouraging strategies that ensure any over-funding can be returned to consumers and that minimise the risk of a surplus being unrecoverable for consumers or being used, for example to de-risk the scheme, in a way that would not otherwise be in the consumer interest. Strategies may include careful management of deficit funding, the use of asset backed funding arrangements as described from paragraph 3.11, and the use of pension contribution holidays, especially when a scheme still has a significant number of active members.

3.44 In the event that an established surplus arises, it may be appropriate for a licensee and the pension scheme trustees to agree a programme of pension contributions below the level that would otherwise be necessary to fund the accruals of benefits for active members and any deficit relating to post cut-off service. These reduced contributions can be called a contribution holiday.

3.45 It is important that a pension contribution holiday, to the extent that it is attributable to an established surplus, is returned to consumers. To achieve this, the Authority will make amendments to the Regulatory Instructions and Guidance, RIGs, that will specify methodologies to determine whether there has been a reduction in the pension contributions in a year as a consequence of an established surplus and the amount of any such reduction. This would be accounted for as a negative contribution to the  $D_y$  term, which could make the  $D_y$  term negative, in paragraph 3.38. To ensure symmetry, the amendments will also specify the inclusion of the same amount as a positive value in Totex (actual Totex), supplementing the actual net contributions that were paid in that year.

3.46 The purpose of these amendments to the RIGs will be to ensure that the identification and attribution of reduced payments to an established surplus are fair and symmetrical to the identification and attribution of increased payments (ie deficit funding) to an established deficit under the Pensions Deficit Allocation Methodology. This will ensure that the interests of consumers, who underwrite the downsides, are protected in the event of upsides.

### *Adjustment factors and Reasonableness Reviews*

3.47 After receiving the whole (or substantially the whole) of the licensee's Scheme Valuation Data Set (see paragraph 3.9) and its proposals for Base Annual PSED Allowances and Payment History Allowances in respect of each defined benefit pension scheme, the Authority will review the way in which the licensee has:

- (c) formulated and justified its proposals for Base Annual PSED Allowances and Payment History Allowances
- (d) engaged with pension scheme trustees and managers to advocate for the interest of consumers with respect to the PSED, recognising the responsibilities of trustees and the regulatory framework they are subject to, recognising the uncertainties that exist in the PSED valuation and recognising the strength of the employer's covenant
- (e) responded to any recommendations set out by the Authority in preceding Reasonableness Reviews
- (f) otherwise followed good practice, informed by practice in the regulated and broader private sectors, taking into account statutory and regulatory factors affecting the relevant pension schemes and the specific

circumstances of each scheme, in promoting consumer interests with respect to the PSED.

3.48 The review referred to in paragraph 3.47 is termed the Reasonableness Review for the purposes of this methodology. Having completed the review, the Authority will consider whether there is any case for:

- (a) making corrections to the licensee's calculations in respect of its proposals for Base Annual PSED Allowances and Payment History Allowances due to data or methodological errors
- (b) determining Base Annual PSED Allowances and Payment History Allowances with different profiles (while maintaining the same overall prospective values) compared with those proposed by the licensee under paragraphs 3.35 and 3.41
- (c) continuing to apply, modifying the scope or modifying the effect of any existing adjustment factors affecting Pensions Allowance values that were put in place following a prior Reasonableness Review, and
- (d) applying any new adjustment factor under paragraph 3.49 below.

3.49 The Authority will only make a determination in respect of paragraph 3.48(b) if it considers the licensee's proposals under paragraphs 3.35 and 3.41 do not appropriately protect the interests of consumers, taking into account statutory and regulatory factors affecting the relevant pension schemes, which may relate to levels of uncertainty in the assumptions adopted in the valuation of the PSED and consequently a concern that the licensee's proposals do not adequately balance the interests of existing and future consumers.

3.50 Consistent with its price control pensions Principle 3, the Authority will only apply adjustment factors referred to in paragraph 3.48(c) and (d) to the extent necessary to disallow any excess costs arising from a material failure in the licensee's responsibility for taking good care of entrusted pension scheme resources on behalf of consumers. New adjustment factors should only arise in the following limited circumstances:

- (a) where the Authority has established the licensee's recklessness, negligence, fraud or breach of fiduciary duty towards consumers, such as failures in its participation in the governance of a pension scheme to correct for poor governance or management of the scheme's resources, including any undue risk of a stranded surplus
- (b) inequitable charges for consumers arising from using the WACC to account for the time value of money in ascertaining the cumulative payment history variance under paragraph 3.38 for any materially accelerated PSED payments that would otherwise have been determined with reference to the discount rate specified in the licensee's Scheme Valuation Data Set
- (c) the licensee's failure to respond adequately to any recommendations set out by the Authority in preceding Reasonableness Reviews

3.51 Any modification to the effect of existing adjustment factors affecting Pensions Allowance values that were put in place following a prior Reasonableness Review will be made after taking equitable account of the time value of money involved, in general with reference to  $hDR_y$ .

3.52 Before deciding to make determinations referred to in 3.48 (b), (c) or (d), the Authority will consult with the licensee, giving its reasons with reference to paragraphs 3.49 and 3.50 and to the Pensions Principles referred to in paragraph 3.5.

3.53 After, considering any representations made by the licensee, the Authority will:

- (a) notify the licensee of its decision
- (b) set out the matters, referred to in paragraphs 3.49 and 3.50, that have led to its decision, and
- (c) Set out the basis on which it considers any adjustment factors referred to in 3.48(c) or (d) might be discontinued at the next Reasonableness Review.

3.54 Where, after consulting with the licensee and giving due weight to the licensee's representations, the Authority considers the licensee is not following good practice which would have the effect of promoting consumer interests with respect to the PSED, the Authority may set out recommendations to the licensee for it to adopt before the next reasonableness review provided:

- (a) the Authority can reasonably establish that adopting the recommendations would not conflict with statutory and regulatory factors affecting the relevant pension schemes
- (b) the Authority takes into account the relative duties of the licensee and the pension scheme trustees and the extent to which the licensee is only able to influence trustee decisions
- (c) the Authority can reasonably establish that adopting the recommendations would be in the interest of consumers and would not disproportionately harm the licensee
- (d) the Authority reasonably believes it is practical for the licensee to adopt the recommendations.

## Section 4 – Pension scheme administration and PPF levy allowances

3.55 This section is not relevant to licensees subject to RIIO-ED1.

3.56 The licensee's actual costs in respect of scheme administration costs and PPF levies will be reported under the annual Regulatory Reporting cycle in accordance with the licence condition specified in the box below.

<i>Price control</i>	<i>Relevant licence conditions</i>
RIIO-GT1	Standard Special Condition A40 (Regulatory Instructions and Guidance)
RIIO-GD1	Standard Special Condition A40 (Regulatory Instructions and Guidance)
RIIO-ET1	Standard Condition B15 (Regulatory Instructions and Guidance)
RIIO-ED1	Not relevant

3.57 Revised APFE and, where relevant, SOAPFE values will be determined in accordance with the steps set out below

- (i) The actual aggregated Pension Scheme Administration and PPF levy expenditure reported by the licensee in its price control review information submissions for each of the years rr-3, rr-2 and rr-1 subsequent to 31 March 2013 will be obtained.
- (ii) The expenditure amounts in (i) will be deflated to the relevant price base, specified in the box below paragraph 3.2, using actual RPI data.
- (iii) The aggregate price control allowances for Pension Scheme Administration and PPF levy expenditure, for each of APFE and SOAPFE if relevant, for each of those years is obtained, to which is added the annual adjustment threshold amount of £1m.
- (iv) For each of those years, if the amount referred to in step (iii) is exceeded by the corresponding amount in step (ii), the excess amount only will be added to the pre-existing price control allowance.
- (v) If the amount at (ii) is less than the corresponding pre-existing price control allowance value at (iii), then no revision to the price control value will be made.
- (vi) The excess at (iv) will be added to the pre-existing APFE and, where relevant, SOAPFE values to determine the revised APFE and SOAPFE values for years rr-3, rr-2 and rr-1.
- (vii) The Authority will review Pension Scheme Administration and PPF levy costs based on actual costs incurred in previous years and known changes to the PPF levies advised by the PPF and, subject to them being considered efficient, reset the existing constituent costs; and the combined existing APFE values for years rr+1, rr+2 and rr+3.



## Section 5 – Reasonableness reviews and revising Pensions Allowance values

3.58 The timetable for revising Pensions Allowance values and for a reasonableness review in a year specified in Table 3.1 is set out in Table 3.2 below.

**Table 3.2 - Process for revising Pensions Allowance values and for a reasonableness review**

<u>Row</u>	<u>Due by</u>	<u>Event</u>
1	7 July*	The Authority will obtain the licensee’s Scheme Valuation Data Set, where relevant separately for its TO and SO activities, for the relevant valuation of the licensee’s defined benefit pension schemes as at the date indicated in Table 3.1 and commence a Reasonableness Review.
2	31 July*	The Authority will be in receipt of price control review information from the licensee for Regulatory Years up to and including the last complete Regulatory Year.
3	31 July*	The licensee will submit: <ul style="list-style-type: none"> <li>(a) Explanations and supporting evidence where appropriate for how it has interpreted the interest of consumers to inform its participation in the governance of pension schemes, including setting investment and risk strategies</li> <li>(b) Explanation of how it has engaged with pension scheme trustees and managers to advocate for the interest of consumers with respect to the PSED</li> <li>(c) Explanation of how it has responded to any recommendations set out by the Authority in preceding Reasonableness Reviews.</li> </ul>
4	31 August*	The licensee will submit, where relevant separately for its TO and SO activities: <ul style="list-style-type: none"> <li>(a) Pension Deficit Allocation Methodology information and its PSED figure as at the relevant valuation date indicated in Table 3.1 showing the movements from the previous valuation date</li> <li>(b) Its proposals where applicable under paragraphs 3.35 and 3.41 together with supporting explanation framed in light of paragraph 3.42 for               <ul style="list-style-type: none"> <li>▪ Base Annual PSED Allowances, PBAPA<sub>y</sub>,</li> <li>▪ payment history allowances, PPH<sub>y</sub>,</li> <li>▪ any proposed prospective discounting basis for payment history variances, reflected in PhDR<sub>y</sub></li> </ul> </li> </ul>
5	30 September*	The Authority will provisionally decide, where relevant separately for the licensee’s TO and SO activities, whether: <ul style="list-style-type: none"> <li>(a) Any change should be made to the licensee’s proposals for Base Annual PSED Allowances and payment history</li> </ul>

Row	Due by	Event
		<p>allowances for reasons anticipated in paragraph 3.48 (a) and (b) and 3.49</p> <p>(b) To apply an existing adjustment factor, introduce a new adjustment factor or extend the scope or effect of an existing adjustment factor for reasons anticipated in 3.49</p> <p>(c) To set out any recommendation to the licensee to adopt good practice before the next reasonableness review under paragraph 3.54</p> <p>The Authority will give notice of any such provisional decisions to the licensee, allowing 14 days for representations to be made.</p>
6	31 October	<p>The Authority will complete its Reasonableness Review, where relevant separately for the licensee's TO and SO activities:</p> <p>(a) Determine the values <math>BAP A_y</math>, representing the Base Annual PSED Allowances, for each of the three years following the reasonableness review, giving reasons for any departure from those proposed in paragraph 3.35</p> <p>(b) Determine the values <math>PH_y</math>, representing the payment history allowances, for each of the three years following the reasonableness review, giving reasons for any departure from those proposed in paragraph 3.41</p> <p>(c) Determine the values <math>AF_y</math>, representing any adjustment factors, for each of the three years following the reasonableness review</p> <p>(d) Compute and determine the Pensions Allowance values for each of the three years following the reasonableness review, such that:</p> $EDE_y \text{ or } SOEDE_y = BAP A_y + PH_y + AF_y$ <p>(e) Where relevant, determine APFE and SOAPFE values in accordance with the steps set out in Section 4</p> <p>(f) Set out any recommendation to the licensee to adopt good practice before the next reasonableness review</p> <p>(f) Determine the discount rates for payment history allowances, <math>hDR_y</math>, or an unambiguous basis for determining them, for each of the three years following the reasonableness review, giving reasons for any departure from those proposed in paragraph 3.41</p>
7	30 November	<p>The Authority will direct revised Pensions Allowance values and will publish a report on the reasonableness review.</p>

\* Or such later date that may be notified to the licensee by the Authority in writing.

*Direction of revised Pensions Allowance values*

3.59 The Authority will direct revised Pensions Allowance values by no later than 30 November in the year of a reasonableness review in accordance with the procedure set out in the licence condition specified in the box below.

<i>Price control</i>	<i>Relevant licence conditions</i>
RIIO-GT1	Part D of Special Condition 5C and Part D of Special Condition 6C
RIIO-GD1	Part D of Special Condition 3C
RIIO-ET1	Part D of Special Condition 6D and Part D of Special Condition 7C
RIIO-ED1	Part D of CRC 3C

3.60 Pensions Allowance values, as revised, are included in full in recalculated base revenue figures in the PCFM under the Annual Iteration Process.