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Date: 13 October 2017

Dear Colleagues

Provisional revised pension allowance values and 2017 reasonableness review

On a triennial basis, during the price control period, we carry out a review of the network operators' (NWOs) pension allowances they can recover as part of their regulated revenue. This letter sets out our provisional view of the revised pension allowances and our recommendations to the NWOs for changes they may want to adopt before the next reasonableness review in 2020.

Appendices 1 and 2 set out the provisional revised allowances that will take effect from 1 April 2018. The total average annual pension allowance for the next three years will reduce from £551 million to £498 million, a net reduction of £53 million. This reduction has been driven by the latest actuarial valuations and a change in approach by some companies in managing their pension schemes. We are proposing a minor increase to the separate administration and pension protection fund (PPF) allowances.[1]

We consider that the clarity we provided in our recent reforms to our pension scheme established deficit policy will give NWOs an opportunity to consider alternative approaches to repair their deficits in the future. This should focus on promoting the interests of consumers in their participation in the governance of pension schemes. We are pleased that some NWOs, anticipating our reforms, have already taken the opportunity. We highlight these in this letter. As part of this review we highlight where we believe NWOs have already done this.

Background

The defined benefit (DB) pension schemes sponsored by most NWOs have their roots in employee remuneration packages, which existed before privatisation of the energy networks between 1986 and 1991. The present position reflects that legacy. All of these pension schemes are now closed to new members, but continue to accrue obligations in respect of pensionable service of existing members. The obligations (£46.0 billion) and the assets (£40.2 billion) held by the schemes to fund those obligations remain substantial relative to the size of the businesses themselves. In addition, the benefits available to employees of electricity networks at the time of privatisation are subject to protected persons legislation[2].

[1] Administration and PPF levy allowances only relate to RIIO-T1 and GD1 price controls.
[2] The Electricity (Protected Persons) (England and Wales) Pension Regulations 1990 (SI 1990/346).

For DB schemes, funding requirements for accrued obligations are highly uncertain because factors such as fund investment returns and longevity assumptions can vary. Contributions made by the employer (and, where appropriate, the member) at the time of a member's pensionable service are generally calibrated to cover the estimated obligation accrued as a result of that service. However, market, general levels of changes in longevity and other developments can render those initial assumptions either too cautious or not cautious enough. As a result, scheme surpluses or deficits can arise.

We introduced price control pension principles in 2003 to guide our approach to dealing with pension costs and in particular, the costs associated with deficit funding. We reviewed those principles in 2008[3] and committed to the funding of deficits arising from pensionable service accrued prior to the end of the price control periods in operation at that time.[4] We call these established deficits. In April 2017, we clarified our policy[5] and the nature of our commitment to provide funding for PSEDs of NWOs subject to price control under our RIIO regimes. This clarification led to revisions to the statement of guidance on our pensions principles and significant changes to the chapter in the price control financial handbook (financial handbook)[6] that governs the treatment of pensions costs across successive price control periods.

We set out our revised guidance on our pensions principles. While we did not change the principles themselves, the revised guidance:

- clarified our commitment in those principles to the funding of any established deficit,
- pointed to improved flexibility around the timescale of funding, and
- reflected our clearer understanding of the respective roles and responsibilities of employers and pension fund trustees.

Reasonableness review and revision of pension allowances

Chapter 3 of the financial handbook for each sector sets out the timetable for the reasonableness review and the methodology for revising pension allowance values.

We appointed the Government Actuary's Department (GAD) to review the NWOs submission. We asked them to give a high-level view on the NWOs pension costs, identifying any material changes in assumptions in the NWOs actuary reports, this built on their review from 2014. We also asked for their view on how the NWOs have considered the interests of consumers to inform the NWOs' participation in the governance of their pension schemes.

A draft summary of GAD's findings on pension costs are as follows:

- Overall, they have no substantive concerns with the changes to the method and assumptions used to determine the NWOs' defined benefit pension costs at the most recent valuations.
- They identified several notable changes, which are outlined in their draft report. However, given the constantly changing nature of a pension scheme and the wider environment, they recognised that some changes would occur between valuations.

GAD have based their draft report on the information submitted to us by the NWOs, however, the NWOs have not yet had opportunity to review GAD's draft report. GAD will not finalise their report until the NWOs have had the opportunity to comment. We will

[3] https://www.ofgem.gov.uk/publications-and-updates/price-control-pension-principles
[4] These cut-off dates are 31 March 2010 for electricity distribution networks, 31 March 2012 for electricity and gas transmission networks and 31 March 2013 for gas distribution networks.
[5] https://www.ofgem.gov.uk/publications-and-updates/decision-ofgems-policy-funding-pension-scheme-established-deficits
[6] https://www.ofgem.gov.uk/publications-and-updates/latest-price-control-financial-handbooks-riio-network-operator-licensees

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publish the final GAD report by end of November 2017 when we make our decision on the revised pension allowances.

We have also reviewed the NWOs submissions and considered the following:

- What changes, if any, should be made to the NWOs proposed base PSED allowances and payment history.
- Whether to apply any adjustment factors.
- Whether to set out any recommendations to the NWOs to adopt good practice before the next reasonableness review (see section below).

The section below 'Interpreting the views of consumers' includes a summary of GADs' views on how the NWOs have considered the interests of consumers.

At the 2014 reasonableness review, we said we would review administration expenses. We also considered that the PPF levy allowances should also be reviewed as part of administration expenses; this is consistent with the financial handbook, with the review based on actual costs incurred in previous years and known changes to the PPF levies advised by the PPF.

We have made no changes to the base PSED proposed by the NWOs. Allowances for all NWOs have remained constant or reduced.

For pension payment history (PPH), we have made changes to UKPN's proposal, but have accepted the remaining NWOs' proposals. For UKPN we do not accept their profiling for the recovery of underfunded/overfunded payment history. Their submission proposed to recover £102 million over the first three years from 2018-19 and then return £10 million over the following seven years, a net recovery of PPH of £92 million. We consider it appropriate to recover the full PPH using a flat profile over the first three years. This will reduce UKPN's proposed PPH allowance for the three years from 2018-19 from an annual average of £34.1 million to £30.7 million.

Appendix 1 sets out the proposed allowances and current established deficit, and compares this with the previous reasonableness review.

We do not consider there is a need to apply an adjustment factor to any of the NWOs pension allowances.

For the administration and PPF levy, we are proposing not to adjust the current allowances for the remainder of RIIO-T1 and GD1. We have reviewed actual expenditure and compared this with the allowance set at the start of the price controls. For the next price control, RIIO2, we propose to adopt the same approach for transmission and gas distribution NWOs that applies as part of RIIO-ED1. This is where administration and PPF levy costs are included as part of totex. We consider that this approach will ensure any efficiencies will be shared between the consumer and the NWO.

NGGT and Cadent have forecast an increase in their administration and PPF allowance from an average of £3.0 million to £4.2 million per year; this includes an annual increase of £0.2 million for PPF contribution. Their average actual annual costs for the three years 2014-2016 was £3.3 million with actual costs in 2016 of £3 million. We consider that the proposed increase by NGGT and Cadent is due to the NGGD sale and sectionalisation of their pension scheme (see below). We do not consider it appropriate that consumers should bear this additional cost and we will only adjust their allowances by the increase in PPF contribution. However, we reallocated their allowance 50/50 between NGGT and Cadent, the allocation is consistent with their submission.

SGN's reports an increase in administration costs from £1.3 million in 2009-10 to £3.6 million (2009-10 prices) in 2015-16. SGN explain that this relates to changes in the

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Scheme's Investment Managers and the investment strategy. We note that SGN's administration and PPF levy costs are exceptionally high. Appendix 2 shows that relative to the size of the scheme they are more than double that of other schemes. We are not satisfied that this is efficient we will maintain the SGN annual allowance at £1.2 million.

A summary of the administration and PPF allowances and our analysis is in Appendix 2.

NGGD (Cadent) sale – Sectionalisation of the National Grid UK Pension Scheme

NGG's DB pension scheme, the NGUKPS, was divided into three separate and independent sections through a process known as sectionalisation, to provide a clear and appropriate allocation of pension responsibilities between the different parts of National Grid's businesses. This was done with the agreement and collaboration of the scheme trustees, and took effect from 1 January 2017.

We consider this helps provide better scope for consumer led governance of the schemes. Allowances sought by the two companies represent a reduction in annual pension allowances of £5.0 million.

Interpreting the interest of consumers and the next reasonableness review

As part of the reasonableness review, we required the NWOs to submit explanations and supporting evidence for how they have interpreted the interests of consumers to inform their participation in the governance of pension schemes, including setting investment and risk strategies. Our emphasis on companies adopting consumer-led pension strategies is new and arises from our April 2017 decision. Given how recent this change is, we weren't necessarily expecting to realise the benefits as part of this reasonableness review, but we would expect a shift in the NWOs' approach in their governance of their pension schemes in the future.

However, we are pleased that a number of NWOs, anticipating our reforms, have already taken the opportunity to consider alternative approaches to repair their deficits in the future and even to reframe their strategy for the governance of their pension schemes to further the interests of consumers. In general, companies cite some consideration of the consumer interest. Some have carried out research and more detailed analysis to discern where the consumer interest lies.

The most extensive work has been carried out by WPD, which commissioned a wide ranging evaluation of possible pension strategies, drawing from the underlying economics behind social discount rates and developing a methodology for detailed quantitative research. This led to new conclusions around the optimal investment portfolio and funding strategy. Other companies have reached different conclusions, and some have indicated to us they do not agree with WPD's approach.

Notably, NPg has also carried out consumer research to inform its strategy, although it reached some different conclusions to WPD.

Whether or not WPD's approach (or NPg's) is the right one, we believe this work has set useful reference points for evidence-gathering in determining optimal strategies. We believe this raises some challenges for companies to address before the next reasonableness review.

One of the key dimensions of pensions strategy is the approach to risk. In large part this is about what kind of investment portfolio is appropriate, making choices between assets with higher expected returns but higher risk or assets with lower expected returns and lower risk. It is also about mitigating, hedging or otherwise managing risk on the liability side, for example by hedging against longevity uncertainty.

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As schemes become more mature, it is conventional in company-funded schemes to adopt lower risk strategies, but the level of risk is a judgement that needs to be made and there are trade-offs between risk and return. One of the challenges for NWOs is to interpret the consumers' interests in managing these trade-offs.

From the two main research initiatives we have reviewed, WPD reaches a conclusion that "from a consumer interest perspective, the most efficient pensions strategy currently is one which has some exposure to the variability (and potential upside) from return seeking assets", while NPg concludes that "when taking significant financial decisions our consumers prefer certainty and are risk averse". These conclusions appear to be quite different.

We recognise that our reformed policy, in clarifying the centrality of the consumer interest in NWO's involvement in these DB schemes, is raising new questions such as this one about risk. We also recognise that it may take some time for the companies to develop more nuanced understandings of consumer preferences and what they mean for pensions strategy. Since there may be a significant generic aspect to these questions – for example, consumer attitudes to risk may not differ much between networks – there would seem to be room for a consensus views to emerge in due course. We would encourage NWOs to collaborate and perhaps involve other organisations, for example consumer protection organisations such as Citizens Advice, to this end. Developing an authoritative and collective consensus would help underpin the public legitimacy of companies' approaches.

Until we have an authoritative and collective consensus, we would remain concerned that de-risking approaches would have a detrimental effect of burdening consumers with relatively high costs.

Of course, there is an interaction between approaches to risk and the dangers of stranded surpluses. A surplus arises when the assets in a scheme are more than enough to fund the scheme's liabilities, and a surplus becomes trapped or 'stranded' if there is not enough flexibility in the scheme's funding to get surplus value back, for example by reducing the level of ongoing contributions for existing members still in service (a contribution holiday). Our policy would ensure an appropriate return to consumers in the event of a contribution holiday. A detriment for consumers would arise if the scope to return a surplus is limited, for example when there is not enough ongoing accrual of new liabilities for existing in-service members. This situation would indicate that too much has been paid into the scheme. For the consumer-funded established portion of any surplus, it would mean consumers have paid too much.

There is a strong interaction between the risk of a stranded surplus and the approach to other risk in the schemes. The possibility of a stranded surplus would effectively cut-off some of the potential upside from other risk, which would point towards lower risk strategies as a scheme becomes more fully funded.

One possible approach to this interaction which could allow a scheme to adopt a higher risk, higher return strategy for longer (for the benefit of consumers) would be to maintain a higher deficit level for longer through an extended funding plan. Given the strength of the covenants, underwritten by the regulator's funding commitment, this might be acceptable to the trustees and positive for consumers.

A second approach would be to adopt an asset-backed mechanism to give trustees the assurance they need while securing the scope to return value to consumers in the event that those assets are no longer needed to fund payments into the scheme itself. Some companies have actively explored asset-backed arrangements, and notably NGN are implementing such an arrangement, which we would encourage for these reasons.

A third approach would simply be to ensure the discussions between the NWO and the trustees give appropriate weight to the risk of stranded surpluses and adopt more cautious

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assessments of the funding requirement. We note that NG has, for practical purposes, adopted a lower deficit valuation than that assessed by the scheme actuary. We see this as positive for consumers.

Avoiding stranded surpluses was one of the main themes in our reform proposals, something we are explicitly looking to NWOs to manage. Unless we have clear evidence that consumers would prefer higher cost but lower risk approaches, we would be concerned that a de-risking strategy may not be a consumer-optimised way of doing so.

Developing consumer-led strategies with these kinds of considerations will not be straightforward, but we believe that securing public confidence that NWOs are working towards consumer-driven objectives, preferably with an authoritative and collective consensus, would be highly desirable.

There will not be a 'one-size fits all' approach to managing the pension schemes, and various factors will influence this, eg size of deficit, profile of members. However, the clarity we provided in April 2017 should provide trustees with confidence that funds will be available when required, irrespective of risk.[7] Both NWOs and trustees should consider alternative risk management that may benefit consumers in the future.

The final version of the GAD report will provide further detail on how the NWOs have interpreted consumer interest for this review.

For the next review, we would hope and expect the NWOs to address these challenges in ways that will help secure that public confidence. The work done so far by some of the companies provides a good foundation for those efforts.

Yours faithfully,

Ian Rowson
Associate Partner, RIIO Finance

[7] Subject to any determined adjustment factor, see relevant financial handbook paragraph 3.47-3.54.

Appendix 1 – Summary of proposed Pension Scheme Established Deficit revenue allowances

Table A1.1: Revised allowances following Ofgem 2017 Reasonableness Review (for 2017 AIP) - 2009-10 or 2012-13* prices

Price Control	Licensee	Licence term	Average Allowance 2014 Reasonableness Review	Average Allowance 2017 Reasonableness Review	Variance	Variance	*Variance 2016-17 prices*
			£m	£m	£m	%	£m
ED1	ENWL	EDE	15.8	11.6	(4.2)	-27%	*(4.6)*
	NPgN	EDE	14.4	11.1	(3.3)	-23%	*(3.6)*
	NPgY	EDE	6.9	5.3	(1.5)	-22%	*(1.7)*
	WMID	EDE	32.6	32.6	(0.0)	0%	*(0.0)*
	EMID	EDE	31.8	31.9	0.0	0%	*0.0*
	SWALES	EDE	25.4	25.4	0.0	0%	*0.0*
	SWEST	EDE	38.1	38.1	(0.0)	0%	*(0.0)*
	LPN	EDE	39.8	36.9	(2.8)	-7%	*(3.1)*
	SPN	EDE	34.1	28.7	(5.3)	-16%	*(5.7)*
	EPN	EDE	15.3	16.8	1.5	10%	*1.7*
	SPD	EDE	28.1	28.5	0.4	1%	*0.4*
	SPMW	EDE	27.7	26.6	(1.1)	-4%	*(1.2)*
	SSEH	EDE	12.9	4.5	(8.3)	-65%	*(9.0)*
	SSES	EDE	32.2	22.3	(9.9)	-31%	*(10.8)*
ET1	SHE - Transmission	EDE	1.5	1.6	0.1	8%	*0.1*
	SPTL	EDE	2.1	2.5	0.4	20%	*0.5*
	NGET TO	EDE	32.6	27.9	(4.7)	-15%	*(5.8)*
	NGET SO	SOEDE	9.9	8.5	(1.4)	-14%	*(1.7)*
GD1**	East	EDE	3.5	10.2	6.7	See table below	*8.2*
	London	EDE	2.4	6.1	3.8		*4.6*
	North West	EDE	2.7	7.1	4.5		*5.5*
	West Midlands	EDE	1.9	5.2	3.3		*4.1*
	Northern	EDE	7.0	3.7	(3.3)	-47%	*(4.1)*
	Scotland	EDE	5.9	6.3	0.4	7%	*0.5*
	Southern	EDE	8.9	9.6	0.7	8%	*0.9*
	Wales & West	EDE	7.2	7.7	0.4	6%	*0.5*
GT1**	NGGT TO	EDE	49.4	25.7	(23.7)	See table below	*(29.1)*
	NGGT SO	SOEDE	0.8	1.4	0.5		*0.6*
	Total		**490.8**	**443.7**	**(47.1)**	**-10%**	***(52.8)***

* 2009-10 price base for RIIO-ET1/GD1/GT1 and 2012-13 for RIIO-ED1
** See table below with summary of NGUKPS sectionalisation following the NGGD (Cadent) sales

Table A1.2: Sectionalisation of the NGUKPS following NGGD sales - 2009-10 prices						
Pension Scheme	**Licensee**	**Licence term**	**Average 2014 Reasonableness Review**	**Average 2017 Reasonableness Review**	**Variance**	**Variance**
			£m	**£m**	**£m**	**%**
NGUKPS	East	EDE	3.5	10.2	6.7	191%
	London	EDE	2.4	6.1	3.8	158%
	North West	EDE	2.7	7.1	4.5	168%
	West Midlands	EDE	1.9	5.2	3.3	173%
	NGGT TO	EDE	49.4	25.7	(23.7)	-48%
	NGGT SO	SOEDE	0.8	1.4	0.5	61%
	Total		**60.7**	**55.7**	**(5.0)**	**-8%**

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Table A1.3: Of which Pension Payment History (PPH) accounts for:

Price Control	Licensee	Licence term	Average 2017 Reasonableness Review
			£m
ED1	ENWL	EDE	(5.4)
	NPgN	EDE	(0.9)
	NPgY	EDE	(0.4)
	WMID	EDE	4.5
	EMID	EDE	4.4
	SWALES	EDE	1.5
	SWEST	EDE	1.7
	LPN	EDE	14.6
	SPN	EDE	14.5
	EPN	EDE	5.0
	SPD	EDE	3.3
	SPMW	EDE	2.7
	SSEH	EDE	2.7
	SSES	EDE	-
ET1	SHE - Transmission	EDE	1.1
	SPTL	EDE	0.5
	NGET TO	EDE	(0.7)
	NGET SO	SOEDE	(0.2)
GD1	East	EDE	(0.4)
	London	EDE	(0.3)
	North West	EDE	(0.3)
	West Midlands	EDE	(0.2)
	Northern	EDE	-
	Scotland	EDE	0.5
	Southern	EDE	0.9
	Wales & West	EDE	0.5
GT1	NGGT TO	EDE	1.7
	NGGT SO	SOEDE	0.1
	Total		**51.4**

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Appendix 2 – Summary and analysis of administration and PPF allowances

Table A2.1: Total PPF levy and Administration (2009-10 price base)							
Licensee	**Current Average Allowance**	**2013 Actuals**	**2014 Actuals**	**2015 Actuals**	**2016 Actuals**	**Average 2014-2016**	**Allowances following 2017 review**
	£m	£m	£m	£m	£m	£m	£m
NGGT TO	2.6	2.8	2.9	2.6	2.4	2.6	1.5
NGGT SO	-	0.0	0.0	0.0	0.0	0.0	0.1
East	0.1	0.2	0.2	0.2	0.2	0.2	0.6
London	0.1	0.1	0.2	0.1	0.1	0.1	0.3
North West	0.1	0.1	0.2	0.2	0.1	0.2	0.4
West Midlands	0.1	0.1	0.1	0.1	0.1	0.1	0.3
Northern	0.7	0.3	0.4	0.4	0.5	0.4	0.7
Scotland	0.5	0.8	1.1	1.4	1.4	1.3	0.5
Southern	0.7	1.2	1.7	2.0	2.1	2.0	0.7
Wales & West	0.8	1.3	1.3	0.8	0.8	1.0	0.8
SPTL	0.1	0.1	0.1	0.1	0.1	0.1	0.1
NGET TO	1.4	1.9	1.7	1.5	1.3	1.5	1.4
NGET SO	0.4	0.6	0.5	0.4	0.4	0.5	0.4
Total	**7.6**	**9.7**	**10.5**	**9.9**	**9.6**	**10.0**	**7.8**

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Table A2.2: Analysis of Administration and PPF by scheme								
Company Pension Scheme Name	**Company**	**Licensee deficit in the pre Cut-Off Date (Mar 2016 prices)**	**Current Average Allowance**	**Allowance/ deficit Mar 2016**	**Average Actuals 2014-2016**	**Average Actual/ Deficit**	**2016 Actual**	**2016 actual/ deficit**
		£m	**£m**	**%**	**£m**	**%**	**£m**	**%**
NGUKPS	NGG	12,129.6	3.0	0.02%	3.3	0.03%	3.0	0.02%
NGNPS	NGN	504.6	0.7	0.14%	0.4	0.09%	0.5	0.10%
SGNPS	SGN	1,221.6	1.2	0.10%	3.3	0.27%	3.6	0.29%
WWUPS	WWU	550.8	0.8	0.15%	1.0	0.18%	0.8	0.14%
NGET ESPS	NGET	2,911.1	2.5	0.08%	2.0	0.07%	1.7	0.06%
SPPS (SPT element)	SP	181.4	0.1	0.03%	0.1	0.05%	0.1	0.06%

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