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Pension scheme trustees,  
Consumers and their  
representatives; and other  
interested parties

Direct Dial: 020 7901 7416

Email: [RegFinance@ofgem.gov.uk](mailto:RegFinance@ofgem.gov.uk)

Date: 09 October 2020

Dear Colleagues,

### **Provisional revised pension allowance values and 2020 reasonableness review**

On a triennial basis, we review the pension allowances that network operators' (NWOs) can recover as part of their regulated revenue under the price controls. We have reviewed the NWOs' pension submissions, and this letter sets out our provisional view of the revised pension allowances, along with our recommendations to the NWOs for changes they may want to adopt before the next reasonableness review in 2023.

Appendix 1 contains the provisional revised allowances that will take effect from 1 April 2021. Appendix 2 contains the total average annual pension allowance for the next three years which will reduce from £534 million to £322 million, a net reduction of £212 million per year.<sup>1</sup> This reduction is a result of the latest actuarial valuations and changes in approach by some companies in managing their pension schemes.

In our review of the NWOs' submissions, we considered the following:

- What changes, if any, should be made to the NWOs' proposed base pension scheme established deficit (PSEDs) allowances and payment history;
- Whether to apply any adjustment factors; and
- Whether to set out any good practice recommendations for the NWOs to adopt before the next reasonableness review.

Based on our review we propose to make no changes to the base PSED or pension payment history (PPH) proposed by the NWOs. Allowances for all NWOs have remained broadly constant or reduced. Further, we do not consider the need to apply an adjustment factor to

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<sup>1</sup> 2018-19 price base

any of the NWOs pension allowances. We set out our recommendations for the next reasonableness review, below.

## Background

The defined benefit (DB) pension schemes sponsored by most NWOs have their roots in employee remuneration packages that existed before the privatisation of the energy networks between 1986 and 1991. All DB pension schemes are now closed to new members, although they continue to accrue obligations in respect of pensionable service of existing members. NWOs have a current DB pension obligation of £42.6 billion, with £39.9 billion in assets, leaving a deficit of £2.7 billion.<sup>2</sup> Assets that are held by the schemes to fund those obligations remain substantial relative to the size of the businesses themselves. This obligation will continue for several decades, although the liability will diminish as the number of members receiving pension payments reduces. In addition, the benefits available to employees of electricity networks at the time of privatisation are subject to protected persons legislation.<sup>3</sup>

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 calibrated to cover the estimated obligation accrued from that service. However, market conditions, general 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.

In April 2017, we clarified our policy and the nature of our commitment to provide funding for PSEDs of NWOs subject to price control under our RIIO regimes.<sup>4</sup> 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)<sup>5</sup> that governs the treatment of pensions costs across successive price control periods. 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.

The clarity we provided in our reforms to our PSED policy gave NWOs an opportunity to consider alternative approaches to repair their deficits in the future. We believe these alternative approaches should focus on promoting the interests of consumers in their participation in the governance of pension schemes.

## 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 and produce a report of the NWOs' submissions. We asked GAD to provide a high-level view on the pension valuations methodology and assumptions, building on their reviews from 2014 and 2017.

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<sup>2</sup> Nominal price base.

<sup>3</sup> The Electricity (Protected Persons) (England and Wales) Pension Regulations 1990 (SI 1990/346).

<sup>4</sup> <https://www.ofgem.gov.uk/publications-and-updates/decision-of-gems-policy-funding-pension-scheme-established-deficits>

<sup>5</sup> <https://www.ofgem.gov.uk/publications-and-updates/latest-price-control-financial-handbooks-riio-network-operator-licensees>

We also asked for GAD's view on how the NWOs have considered the interests of consumers to inform the NWOs' participation in the governance of their pension schemes. We will publish GAD's final report when we conclude the reasonableness review in November.<sup>6</sup>

GAD have provided us with a draft summary report, their initial findings are as follows:

- Overall, GAD have no substantive concerns with the changes to NWOs' valuation methodologies and assumptions. Where there have been changes, they did not consider these unreasonable.
- GAD found that most NWOs carried out some form of consumer research, which included:
  - Surveys;
  - Focus groups;
  - Feedback;
  - Workshops;
  - As well as considering the analysis of other schemes.
- This research was used to represent consumer interests to:
  - Commission analysis to consider whether actions would be in consumer interests;
  - Negotiate with trustees on valuation concessions; and
  - Engage with trustees on investment strategy.
- All NWOs state that they have:
  - Governance arrangements, which include collaborative working with trustees; and
  - Actively represented consumers in discussions with trustees.
- Some also have:
  - Provided training to trustees on consumer interests; and
  - Requested advisors carry out analysis on, or explicitly consider, consumer interests.
- GAD identified that there is no consensus in approach across NWOs in their management of pension scheme; they consider this acceptable as there is no 'one-size-fits-all' approach.
- GAD questioned whether it was too early to reflect any short-term fluctuations caused by Covid-19 impact, and that NWOs should consider the long-term position.
- Many NWOs have entered into or considered entering into contingent asset arrangements. These included asset backed contributions (ABCs), escrow arrangements or other securities/guarantees.
- Almost all NWOs have provided evidence of liability management.<sup>7</sup> These include:
  - Pension increase exercises;
  - Early retirement, voluntary redundancy, and/or flexible retirement options;
  - Transfer exercises; and
  - Trustee agreement to consider future exercises.
- NWO valuation outcomes led to differing recovery plans, ranging from reduced deficit recovery contributions, extended recovery plans, or maintained contributions, while

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<sup>6</sup> We will share a draft of the final report with NWOs in advance of publication.

<sup>7</sup> Many of these options may have already been in place rather than being new options introduced by the schemes since the last review.

reducing the recovery period, with only one or two schemes increasing contributions.<sup>8</sup>

## **Managing pension surplus**

As part of the 2017 reasonableness review, we highlighted the interaction between approaches to risk and the dangers of stranded surplus. 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 realise the surplus value, for example by reducing the level of ongoing contributions for existing members still in service (a contribution holiday).

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

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, where appropriate, and that minimise the risk of a surplus being unrecoverable for consumers or being used. An example would be to de-risk the scheme in a way that would not otherwise be in the consumer interest (noting schemes should have appropriate regard to the strong sponsor covenant).<sup>9</sup> Strategies may include careful management of deficit funding, the use of asset backed funding arrangements and the use of pension contribution holidays, especially when a scheme still has a significant number of active members.

## **The next reasonableness review (in 2023): interpreting the interest of consumers and stranded surplus**

As part of the 2020 reasonableness review, we asked NWOs to provide explanations and supporting evidence of how they have interpreted the interests of consumers to inform their participation in the governance of pension schemes, including setting investment and risk strategies. The emphasis on companies adopting consumer-led pension strategies arose from our April 2017 decision.

Following review by GAD, we are satisfied that around half of NWOs have implemented or considered contingent assets to reduce prudence (and hence deficit) to negotiate on the deficit repair period or payments, or to pay deficit repair payments via coupons. In general, companies cite some consideration of the consumer interest. All NWOs have governance arrangements including collaborative working with trustees. Some have carried out research, such as surveys, focus groups and analysis to assess which or whether actions fit with consumers' interest. GAD's final report for 2020 will provide a comparison of NWOs' approaches to managing their pension schemes. For the 2023 review, we would expect NWOs to have considered alternative approaches in their management of these schemes.

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

As schemes mature, it is conventional in company-funded schemes to adopt lower risk strategies, but the level of risk is judgemental and there are trade-offs between risk and return. One of the challenges for NWOs is to interpret the continued consumers' interests in

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<sup>8</sup> WWUPS has increased while maintaining the recovery plan end date; and SEESPS, where it is not clear whether they have increased or maintained contributions, as these are RPI-linked (SEESPS reduced the recovery period).

<sup>9</sup> The extent to which trustees can rely on contributions from the sponsor given its willingness and ability to pay

managing these trade-offs, and to avoid a stranded surplus. We will expect that NWOs continue to demonstrate what they are doing to avoid any stranded surplus, and explain their approach to the relevant risks accordingly.

There will not be a 'one-size-fits-all' approach to managing the pension schemes, and various factors will influence this: e.g. funding level, membership profile, scheme maturity, current investment strategy and sponsor covenant. Both NWOs and trustees should consider alternative risk management that may benefit consumers in the future, and that there would seem to be room for a consensus of views to emerge in due course across NWOs, albeit with differing approaches to managing pension schemes.

For the 2023 reasonableness review, we will require continued and/or further evidence of how NWOs have interpreted the interests of consumers.

### *Stranded surplus*

As part of future reasonableness reviews, we will conduct an initial review of any established surplus to identify whether a more detailed review is required. This more detailed review will occur as part of the close-out of RIIO-2, using the latest information available at that time. The review would take into account the mitigating actions a NWO has put in place to manage an unnecessary surplus, prevailing and forecast market conditions, the impact of any pension payment holidays (including the timing of those holidays) and the materiality of the surplus. If the review concludes an adjustment is required, it will be applied as part of the close-out of RIIO-2.

### **Next steps**

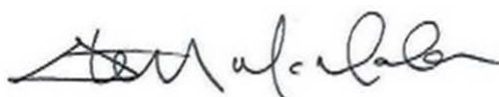
Appendix 1 sets out our proposed allowances, and Appendix 2 shows the current established deficit and a comparison against the previous reasonableness review.

We have also published, for each sector, our notice to revise Price Control Financial Model Variable Values for PSED revenue allowances.

We welcome any responses to the proposals outlined in this letter and any representations on the proposed revision of values. These should be made on or before 23 October 2020 by email to [RegFinance@ofgem.gov.uk](mailto:RegFinance@ofgem.gov.uk).

We will conclude the reasonableness review in November 2020. For electricity distribution, the revised allowances will be reflected as part of the Annual Iteration Process. For gas distribution, electricity and gas transmission and the electricity system operator, the allowances will be in the model that support our RIIO-2 final determinations. It will feed into the Price Control Financial Model, which we will be included in the statutory licence consultation for RIIO-2.

Yours faithfully,



**Steven McMahon**  
**Deputy Director, RIIO Electricity Distribution and Cross Sector**

## Appendix 1 – Summary and analysis of revised pension allowances

**Table 1.1 - Revised pension allowances RIIO -ED1 (£m, 2018-19 prices)**

Licensee	Description	Licence term	2022	2023	2024	2025	2026	Average 2022-24 <sup>1</sup>
ENWL	PSED Revenue Allowance	EDE	12.5	10.9	-	-	-	11.7
NPqN	PSED Revenue Allowance	EDE	12.4	5.0	5.0	-	-	7.5
NPqY	PSED Revenue Allowance	EDE	6.0	2.5	2.5	-	-	3.7
WMID	PSED Revenue Allowance	EDE	40.3	40.3	27.1	-	-	35.9
EMID	PSED Revenue Allowance	EDE	42.0	42.0	28.7	-	-	37.6
SWALES	PSED Revenue Allowance	EDE	15.9	15.9	10.4	-	-	14.1
SWEST	PSED Revenue Allowance	EDE	28.0	28.0	19.7	-	-	25.2
LPN	PSED Revenue Allowance	EDE	19.0	19.0	19.0	19.0	2.4	19.0
SPN	PSED Revenue Allowance	EDE	15.7	15.7	15.7	15.7	2.3	15.7
EPN	PSED Revenue Allowance	EDE	6.8	6.8	6.8	6.8	2.4	6.8
SPD	PSED Revenue Allowance	EDE	28.6	28.6	28.6	28.6	0.2	28.6
SPMW	PSED Revenue Allowance	EDE	29.9	29.9	29.9	29.9	29.9	29.9
SSEH	PSED Revenue Allowance	EDE	-	(3.1)	(3.1)	(3.1)	(3.1)	(3.1)
SSS	PSED Revenue Allowance	EDE	24.4	24.4	18.5	18.5	18.5	22.4

**Table 1.2 - Revised pension allowances RIIO-ET2 (£m, 2018-19 prices)**

Licensee	Description	Licence term	2022	2023	2024	2025	2026	Average 2022-24 <sup>1</sup>
SHE - Transmission plc	PSED Revenue Allowance	EDE	(0.9)	(1.9)	-	-	-	(1.4)
SPTL	PSED Revenue Allowance	EDE	3.0	3.0	3.0	3.0	0.2	3.0
NGET TO	PSED Revenue Allowance	EDE	31.5	31.1	12.6	-	-	25.0
NGET SO	PSED Revenue Allowance	SOEDE	9.6	9.4	3.8	-	-	7.6

**Table 1.3 - Revised pension allowances RIIO-GT2 (£m, 2018-19 prices)**

Licensee	Description	Licence term	2022	2023	2024	2025	2026	Average 2022-24 <sup>1</sup>
NGGT TO	PSED Revenue Allowance	EDE	(11.0)	(11.0)	(11.0)	-	-	(11.0)
NGGT SO	PSED Revenue Allowance	SOEDE	0.7	0.7	0.5	-	-	0.6

**Table 1.4 - Revised pension allowances RIIO-GD2 (£m, 2018-19 prices)**

Licensee	Description	Licence term	2022	2023	2024	2025	2026	Average 2022-24 <sup>1</sup>
East	PSED Revenue Allowance	EDE	11.7	7.2	-	-	-	9.5
London	PSED Revenue Allowance	EDE	6.8	4.3	-	-	-	5.5
North West	PSED Revenue Allowance	EDE	6.6	3.1	-	-	-	4.9
West Midlands	PSED Revenue Allowance	EDE	7.4	5.1	-	-	-	6.3
Northern	PSED Revenue Allowance	EDE	4.7	4.7	13.2	13.2	13.2	7.5
Scotland	PSED Revenue Allowance	EDE	0.5	0.5	0.5	0.5	0.5	0.5
Southern	PSED Revenue Allowance	EDE	0.4	0.4	0.4	0.4	0.4	0.4
Wales & West	PSED Revenue Allowance	EDE	8.4	8.4	8.4	8.4	8.4	8.4

<sup>1</sup> ENWL, SHE Transmission, SSEH and Cadent (East, London, North West & West Midlands) - 2-year average, remainder 3-year average

**Table 1.5 - of which payment history accounts (£m, 2018-19 prices)**

Licensee	Description	Financial handbook term	2022	2023	2024	2025	2026
ENWL	Payment history	PPH	(8.3)	(8.3)	-	-	-
NPgN	Payment history	PPH	(1.7)	(1.7)	(1.7)	-	-
NPgY	Payment history	PPH	(0.8)	(0.8)	(0.8)	-	-
WMID	Payment history	PPH	15.3	15.3	-	-	-
EMID	Payment history	PPH	15.5	15.5	-	-	-
SWALES	Payment history	PPH	6.4	6.4	-	-	-
SWEST	Payment history	PPH	9.7	9.7	-	-	-
LPN	Payment history	PPH	(7.2)	(7.2)	(7.2)	(7.2)	1.4
SPN	Payment history	PPH	(5.7)	(5.7)	(5.7)	(5.7)	1.4
EPN	Payment history	PPH	(2.9)	(2.9)	(2.9)	(2.9)	1.3
SPD	Payment history	PPH	(0.6)	(0.6)	(0.6)	(0.6)	(0.0)
SPMW	Payment history	PPH	2.6	2.6	2.6	2.6	2.6
SSEH	Payment history	PPH	-	(3.6)	(3.6)	(3.6)	(3.6)
SSS	Payment history	PPH	-	-	(3.4)	(3.4)	(3.4)

**Table 1.6 - of which payment history accounts (£m, 2018-19 prices)**

Licensee	Description	Financial handbook term	2022	2023	2024	2025	2026
SHE - Transmission plc	Payment History	PPH	(0.9)	(1.9)	-	-	-
SPTL	Payment History	PPH	0.4	0.4	0.4	0.4	0.4
NGET TO	Payment History	PPH	(5.6)	(5.6)	(5.5)	-	-
NGET SO	Payment History	PPH	(1.7)	(1.7)	(1.7)	-	-

**Table 1.7 - of which payment history accounts (£m, 2018-19 prices)**

Licensee	Description	Financial handbook term	2022	2023	2024	2025	2026
NGGT TO	Payment History	PPH	(11.0)	(11.0)	(11.0)	-	-
NGGT SO	Payment History	PPH	0.7	0.7	0.5	-	-

**Table 1.8 - of which payment history accounts (£m, 2018-19 prices)**

Licensee	Description	Financial handbook term	2022	2023	2024	2025	2026
East	Payment History	PPH	3.3	3.3	-	-	-
London	Payment History	PPH	1.7	1.7	-	-	-
North West	Payment History	PPH	0.5	0.5	-	-	-
West Midlands	Payment History	PPH	0.5	0.5	-	-	-
Northern	Payment History	PPH	-	-	8.5	8.5	8.5
Scotland	Payment History	PPH	0.5	0.5	0.5	0.5	0.5
Southern	Payment History	PPH	0.4	0.4	0.4	0.4	0.4
Wales & West	Payment History	PPH	3.2	3.2	3.2	3.2	3.2

## Appendix 2 – Summary of proposed Pension Scheme Established Deficit revenue allowances

### Revised allowances following Ofgem 2020 Reasonableness Review - 2018/19 prices

Price Control	Licensee	Licence term	Average 2017 Reasonableness Review (2018-19 prices) £m	Average 2020 Reasonableness Review (2018-19 prices) £m	Variance £m	Variance Percentage
ED1	ENWL	EDE	13.4	11.7	(1.7)	-13%
	NPgN	EDE	12.8	7.5	(5.3)	-41%
	NPgY	EDE	6.2	3.7	(2.5)	-41%
	WMID	EDE	37.7	35.9	(1.8)	-5%
	EMID	EDE	36.9	37.6	0.7	2%
	SWALES	EDE	29.4	14.1	(15.4)	-52%
	SWEST	EDE	44.1	25.2	(18.9)	-43%
	LPN	EDE	42.8	19.0	(23.8)	-56%
	SPN	EDE	33.3	15.7	(17.5)	-53%
	EPN	EDE	19.4	6.8	(12.6)	-65%
	SPD	EDE	33.0	28.6	(4.3)	-13%
	SPMW	EDE	30.8	29.9	(0.8)	-3%
	SSEH	EDE	5.2	(3.1)	(8.4)	-160%
	SSES	EDE	25.8	22.4	(3.4)	-13%
	<b>RIIO-ED1</b>		<b>370.9</b>	<b>255.1</b>	<b>(115.8)</b>	<b>-31%</b>
ET2	SHE - Transmission plc	EDE	3.2	(1.4)	(4.6)	-144%
	SPTL	EDE	3.3	3.0	(0.3)	-9%
	NGET TO	EDE	36.6	25.0	(11.5)	-32%
	<b>RIIO-ET2</b>		<b>43.1</b>	<b>26.7</b>	<b>(16.4)</b>	<b>-38%</b>
	NGET SO	SOEDE	11.1	7.6	(3.5)	-32%
GD2	East	EDE	13.3	9.5	(3.9)	-29%
	London	EDE	8.1	5.5	(2.5)	-31%
	North West	EDE	9.4	4.9	(4.5)	-48%
	West Midlands	EDE	6.9	6.3	(0.6)	-9%
	Northern	EDE	4.8	7.5	2.7	57%
	Scotland	EDE	8.3	0.5	(7.8)	-94%
	Southern	EDE	12.6	0.4	(12.3)	-97%
	Wales & West	EDE	10.1	8.4	(1.7)	-16%
	<b>RIIO-GD2</b>		<b>73.5</b>	<b>42.9</b>	<b>(30.5)</b>	<b>-42%</b>
GT2	NGGT TO	EDE	33.7	(11.0)	(44.7)	-133%
	NGGT SO	SOEDE	1.8	0.6	(1.2)	-65%
	<b>RIIO-GT2</b>		<b>35.5</b>	<b>(10.4)</b>	<b>(45.9)</b>	<b>-129%</b>
	<b>Total</b>		<b>534.0</b>	<b>321.9</b>	<b>(212.1)</b>	<b>-40%</b>

\*ENWL, SHE Transmission, SSEH and Cadent (East, London, North West & West Midlands) - 2-year average, remainder 3-year average