Second Consultation on Ofgem's policy for funding Network Operators' Pension Scheme Established Deficits

Consultation

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Overview:

All price controlled energy network operators (NWOs) operate defined benefit pension schemes, and all are closed to new members. In response to concerns expressed by stakeholders, we believe it is appropriate to clarify the nature of our commitment to provide funding for Pension Scheme Established Deficits (PSEDs). In May 2015 we consulted on our proposals for changes to the way PSEDs are funded and evaluated.

This document summarises the responses to our earlier consultation. We have taken into consideration the responses and have modified our proposals where we believe this to be appropriate. We have also provided further clarification where requested

This consultation does not ask specific questions but rather seeks any further comments based upon the detailed proposals in this document.

Context

We published our decision document outlining our current approach to pension costs in June 2010. This approach was applied in the first round of the RIIO price controls. Six years on, with the recent completion of the second pensions reasonableness review and in light of a number of concerns expressed by NWOs and pension fund trustees, we decided to carry out a limited scope review of our approach. This consultation paper sets out our developed proposals for revisions to our approach after taking account of responses to our first consultation paper, which we published in May 2015.

We have a long-standing commitment to consumer funding of deficits in defined benefit pension schemes, which were generally in existence before the energy network sector was privatised. To reflect this commitment, our price controls provide a form of pass-through funding by consumers of 'Pension Scheme Established Deficits' (those attributable to service before certain specified cut-off dates). Our current approach assumes these deficits will be fully repaired over a defined 15-year period. Many of the concerns from interested parties relate to this fixed period.

We believe we can improve our approach to better protect the interests of existing and future consumers.

Associated documents

- Consultation on Ofgem's policy for funding Network Operators' pension deficits (May 2015)[1]
- The Pension Regulator's Code of Practice no. 3 - Funding defined benefits (July 2014)[2]
- Decision Document - Price Control Treatment of Network Operator Pension Costs Under Regulatory Principles - June 2010[3]

[1] https://www.ofgem.gov.uk/publications-and-updates/pension-deficit-funding-policy-consultation

[2] http://www.thepensionsregulator.gov.uk/codes/code-funding-defined-benefits.aspx

[3] https://www.ofgem.gov.uk/ofgem-publications/42784/pricecontroltreatmentofpensioncostsfinal.pdf

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1. Why we are consulting further

Why we saw the need for reform

1.1. Energy network operators (NWOs) have significant obligations under defined benefit pension schemes. These schemes were generally established before the companies were privatised and, in part, their obligations relate to employees' service prior to privatisation.

1.2. All of the schemes are now closed to new members. Nevertheless, the assets of these schemes compare with the size of the network businesses themselves and, in some cases, exceed the value of the network's Regulatory Asset Value (RAV). Our regulatory regimes have sought to ensure that NWOs' investors and managers are focused on improving the efficiency of their network services and not distracted by the potentially significant swings in the performance of their pension schemes which, in large part, are outside their control. We have sought to protect NWOs from the related financeability risks, and to protect consumers from potentially detrimental impacts on the NWOs' investment programmes and the services they provide.

1.3. Accordingly, our historical practice has been, and our existing commitment is, to provide for consumer funding of pension scheme deficits that relate to regulated networks.[4,5] We seek to ensure that consumers, who are underwriting the downside risks in these schemes, also have access to the upside if investment performance or pension liabilities turn out to be better than the prudent assumptions in actuarial valuations.

1.4. In our May 2015 consultation paper, we identified some problems with our existing formal commitment for consumer funding of Pension Scheme Established Deficits (PSED) over a fixed 15-year period.[6] In particular, we referred to a lack of clarity around what would happen after the end of the 15-year period and to the acute issues that would arise if pension scheme deficit valuations varied significantly towards the end of that period.

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[4] Our principal commitment applies to Pension Scheme Established Deficits, those accrued for service prior to the cut-off dates which are 31 March 2010 for electricity Distribution Network Operators (DNOs), 31 March 2012 for electricity and gas Transmission Owners (TOs) and System Operators (SOs) and 31 March 2013 for Gas Distribution Networks (GDNs). Ongoing pensions expenses (for scheme members' service after the cut-off dates) are included as part of benchmarking total costs (totex) and subject to the same incentive mechanisms as other Totex expenditure.

[5] The scale of the deficits for the NWOs as at 31 March 2013 (the date of the last full triennial valuation) was around £7.5 billion, with the Established Deficits portion (the portion that is funded by consumers) being around £5.9 billion.

[6] It was hoped that during those 15 years, there would be greater certainty about the level of the deficits. In practice, continuing market uncertainties indicate there will remain significant uncertainty in deficit estimates.

1.5. In our previous consultation we set out proposals for a more flexible and enduring commitment. Respondents to that consultation paper broadly supported our proposals.

1.6. We also outlined a marked shift from our current approach, that envisages penalties for NWOs that are outliers in the way their Pension Scheme Established Deficits are managed or valued, to a new approach that looks instead to NWOs to demonstrate how they are participating in the governance of pension schemes on behalf of the consumers (who are underwriting the risks involved). We believe this approach more constructively recognises the substance of relationships between NWOs and pension scheme trustees who are ultimately responsible for the schemes. Respondents also broadly supported the direction of this thinking.

1.7. The aim of our proposed reforms is two-fold:

(a) to underline Ofgem's commitment to consumer funding of Pension Scheme Established Deficits, which should help to minimise the cost of financing the networks themselves to the benefit of consumers, and

(b) to encourage NWOs to pursue consumer-focused strategies for managing their commitments.

Why we are consulting further

1.8. These are important proposals for NWOs and while most responses were generally supportive we recognise the need for additional clarity about what they would mean in practice. We would also like to address concerns raised in consultation responses, particularly about the potential impact on the relationships between companies and pension scheme trustees.

1.9. To address these concerns, we have in particular focused on:

(a) how we recognise the primacy of pension fund trustees

(b) how our licensee ring fencing protections can help trustees gauge the covenant strength, and

(c) how NWOs can propose new Pension Scheme Established Deficit repair profiles.

The primacy of pension scheme trustees

1.10. We believe it is important for us to acknowledge the primacy of the pension scheme trustees in the management of pension schemes. The code of practice (no. 3) for funding defined benefits, issued by the Pensions Regulator in July 2014 (see Associated Documents), talks about how employers being able to fulfil their obligations helps trustees to achieve their key funding objective. NWOs have responsibilities towards their consumers and the strength of the employer covenant is in part underpinned by our funding commitment on behalf of consumers. This means we can reasonably look to NWOs to represent the interests of consumers when they participate in pension scheme governance. We have worked closely with the Pensions Regulator to ensure our proposals respect the responsibilities of trustees.

1.11. We are not aiming to influence trustees directly. Instead, we are looking to incentivise NWOs to adopt a positive approach to regulatory business governance. We leave it to the Pensions Regulator to guide trustees on how they might take NWOs' consumer advocacy into account.

The importance of ring fencing in assessing covenant strength

1.12. In respecting the responsibilities of trustees, we know we cannot make presumptions about how secure they feel about the continued regulatory funding of deficits. Our regulatory regimes do evolve, but there are some underlying principles which, for good policy reasons, should endure. Our duty to have regard to the financial security of operators of essential network infrastructure is one of them.

1.13. The NWOs are subject to ring fencing protections in licence conditions, underpinned by legislation. The purpose of ring fencing is to reinforce the protections within our price control regimes to maintain the financial security of licensed entities. NWOs are under an enforceable obligation to take all appropriate steps within their power to maintain an investment grade issuer credit rating. This imposes a high standard of financial discipline and effectively imposes limits on the ability of owners to extract value from their regulated subsidiaries.

1.14. Although ring fencing is aimed at protecting the interests of consumers, it does so by also protecting the interests of creditors, which would include pension schemes[7].

1.15. We believe the onus is on us and the NWOs to communicate and explain the effect of the ring fencing regime, and how it interacts with our commitment to funding pension scheme deficits, the medium and long term outlook for the sector as provider of essential services and the strength of the employer's position in its sector as a natural regulated monopoly. This should help to inform the judgements that trustees must make around the strength of employer covenants in light of guidance issued by the Pensions Regulator.[8] We believe our regime makes those covenants especially strong, but we recognise that it is for trustees to make that judgement, not us. We also recognise that the assessment of how to act in light of the covenant strength is also a matter for trustees, in discussion with the sponsoring employer.

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[7] To illustrate, in its 13 November 2015 credit research outlook for UK regulated utilities, Santander expressed the view that *"Most of the UK regulated opcos issue bonds directly in their own right. These bonds are protected by regulatory ring-fencing and we view them as among the lowest-risk bonds in the corporate universe."*

[8] For example regulatory guidance for defined benefit schemes, 'Assessing and monitoring the employer covenant' published in August 2015.

Pension Scheme Established Deficit repair periods and the interests of consumers

1.16. We are looking to NWOs to place consumers at the heart of how they participate in pension scheme governance.

1.17. When we consider the consumer interest, we are equally concerned about today's and tomorrow's consumers. A key principle at stake is about the balance between those two populations of consumers: 'inter-generational equity'. It is not per se in the consumer interest to defer funding, but funding a material deficit over a short period could be placing the burden too much on today's consumers.

1.18. We therefore believe we should have a reference point for funding periods for Pension Scheme Established Deficits that avoids costs being unnecessarily focused on one group of consumers. The quality of the covenant that schemes have when they are sponsored by regulated energy networks suggests that it may be safe to fund deficits over longer periods than would be appropriate for schemes that do not benefit from these regulatory protections. However, this is ultimately something that trustees must judge, and NWOs are in a position to inform those judgements.

1.19. Many respondents pointed out that generally a stronger covenant would imply a shorter agreed deficit repair period. While we accept this point applies to employers in general, we believe the context of consumer funding adds a different dimension and points to longer recovery periods. In the case of NWOs, unduly short deficit repair periods would impose burdens on a focused group of consumers rather than on the companies. It may be more equitable or acceptable to spread the burden more evenly between today's and tomorrow's consumers. We believe that giving and being seen to give weight to the consumer perspective in this way could help underpin the sustainability of our pension deficit funding regime and the strength of the employer covenant. We aim with our proposals to make it easier for employers to bring forward deficit funding where it is necessary, but also to encourage employers and trustees to understand where doing so may not be desirable or beneficial in the longer run.

1.20. We have translated our proposals into draft revisions to the methodology for revising Pension Scheme Established Deficit repair allowances in RIIO price controls. Our illustrative drafting (based on the existing methodology in the RIIO-ED1 Price Control Financial handbook[9]) is outlined in chapter 3, and shown in a draft updated methodology at Appendix 2.

1.21. Our proposals also provide for a refocused triennial pensions reasonableness review. In particular, our reviews will not be seeking to substitute our assumptions for those made by an appropriately qualified and appointed actuary in assessing the value of a pension scheme deficit. We recognise that these assumptions affect today's understanding of the scale of a deficit but should not affect the longer term cost to the consumer of funding it.

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[9] https://www.ofgem.gov.uk/publications-and-updates/riio-ed1-price-control-handbook-slow-track

A note on surpluses

1.22. While our proposals would provide for more flexibility in the funding of established deficits, we need to be sure that consumers receive a fair share of any benefit made possible when a scheme is in surplus. Although the prospect of pension contribution holidays in respect of active members might now seem remote, our funding regime at present does not provide a mechanism to return a fair proportion of any such benefit to consumers. Our proposals therefore include a small change to the Pensions Deficit Allocation Methodology (specified in paragraph 3.37 below), and to the Financial Handbooks (see paragraphs 3.35 and 3.37 in Appendix 2). These changes would allow any reduction in ongoing contributions made possible because of an established surplus (for pensionable service prior to the respective cut-off dates) to be returned to consumers.

Responding to this consultation

1.23. In this consultation, we are looking for responses to our proposals taken as a whole. We therefore invite any further comments based upon the details in this document and request your responses by 27 April 2016 (also, see Appendix 3). Please email your responses to RegFinance@ofgem.gov.uk.

2. Responses to our earlier consultation

2.1. We received 21 responses to our May 2015 consultation from NWOs, pension trustees, trades unions, consultants and others. The non-confidential responses can be viewed on our pension deficit funding policy consultation page.[10]

2.2. In this second consultation we do not provide detailed comments on each response but rather provide a commentary on the overall message from responses, taken in the round, but we also address specific concerns that have been raised where appropriate.

2.3. We set out our commentary below in the order of the chapters in our May 2015 consultation paper.

Reasons for change

2.4. In chapter 1 of our consultation paper, we identified that pension scheme assets typically are equivalent to about one half of the Regulatory Asset Value (RAV) for NWOs. This means NWOs could be exposed to uncertainties in investment markets, uncertainties that are relevant to the cost of capital. We explained our belief that clarifying our commitment to fund Established Deficits would help to minimise the cost of capital and therefore protect the interests of both existing and future consumers.

2.5. We asked if you agree.

Responses

2.6. Most respondents agreed that the proposals will reduce risk and, therefore, mitigate any adverse cost of capital impacts. Several respondents, in particular those from pensions trustees, did qualify their responses by seeking further clarification on the proposals, especially around extending the deficit repair period. Some respondents suggested that uncertainty through a lack of clarity could increase perceptions of risk and therefore have an adverse impact on the cost of capital.

Our position

2.7. We welcome the general consensus that our proposals have the potential to offer protection against any adverse cost of capital impacts. However, the potential benefit to consumers depends critically on us making sure there is clarity in our funding commitment. We believe our proposals, which we summarise in chapter 3 and articulate in more detail in Appendix 1 and Appendix 2, will provide this clarity.

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[10] https://www.ofgem.gov.uk/publications-and-updates/pension-deficit-funding-policy-consultation

Funding period

2.8. In chapter 2 of our consultation we described our commitment to provide for consumer funding of Established Deficits. Our current arrangements provide for the full funding of these deficits over a 15-year period from the cut-off dates. We explained our concern that, as the end of the 15-year period approaches, NWOs (and trustees) may have an incentive for excessive prudence in valuation assumptions which could disadvantage consumers. Given the strength of the employer covenant we believe that deficit recovery periods can be spread over reasonable periods which balance the needs of current and future consumers. We proposed that NWOs should be in a position to inform trustees' deficit funding decisions with the consumer interest in mind. We proposed not to specify what the funding profile should be but to place an onus on NWOs to explain how consumer interests have been protected.

2.9. We asked for your views on our proposals and if you agree that our commitment to funding Established Deficits should be clarified?

Responses

2.10. The proposal to provide flexibility for the Established Deficit funding period, and in particular allowing the period to be extended, generated a diversity of responses. Trustees were generally opposed to extending the deficit repair period beyond what they already regard as too long. They claimed that this is contrary to their duties to members (as opposed to consumers), it could weaken the covenant and it could impact on future consumers who have no connection to the original deficit. They also felt that strong covenants should equate to shorter, and not longer, deficit repair periods.

2.11. Several respondents suggested that closer integration with the Pension Regulator's (TPR) recommendations would help to satisfy concerns raised by trustees. Some suggested that the Pensions Regulator should provide specific guidance with respect to regulated industries.

2.12. Some respondents believed that the risk of over-prudent valuations arising towards the end of the current 15-year period is unfounded.

2.13. Nearly all respondents sought further clarity on the proposals.

Our position

2.14. Consumer interest is at the core of our policy, ie it is our primary objective to protect the interests of existing and future consumers. Although this objective is different from the Pensions Regulator's objective to ensure pension member benefits are protected, both we and the Pensions Regulator believe that these objectives can be compatible. The Pensions Regulator has, for example, expressed to the Energy Networks Association its view that the effective management by trustees and employers of risks in their pension schemes can accommodate network employers incentivised by Ofgem to take consumer interests into account and that, conversely, Ofgem's approach does not preclude trustees acting in scheme members' best interests.

2.15. We do not believe we can meaningfully connect any particular group or generation of consumers to an original deficit. A deficit generally arises because of unanticipated changes in longevity or market circumstances or assumptions. If employers and trustees had had perfect foresight, costs attributed to consumers prior to the cut off dates would have been different. However, the consumers affected then are likely to be quite remote from the existing and future consumers who will be affected now.

2.16. Although we understand the concerns raised by the trustees we do not concur with the assertion that a strong covenant demands a shorter recovery period. The strength of the covenant in these regulated businesses in large part derives from their ability to raise revenues from current and future consumers, including the funding of Established Deficits. Shorter recovery periods would impose burdens on current consumers, not on the companies. The strength of the covenant (relating to the company) does not reflect how appropriate an increase in funding level would be for those effectively paying for it (consumers).

2.17. The strength of the covenant is supported by long-term regulatory certainty, with NWO's allowed revenues set to secure their financing requirements, and robust ring fencing arrangements. Our assessment is that these features make energy network operators unusually safe businesses. This is if anything enhanced when regulatory arrangements are seen to operate in the consumer interest. We therefore expect it will be in members' interests to work constructively with NWOs as they represent the interests of consumers as well as shareholders while participating in the governance of pension schemes.

2.18. Although we have no explicit evidence that excessively prudent valuations would arise towards the end of the existing 15-year funding period, we have identified potentially strong incentives to influence higher deficit valuations towards the end of the 15-year period. We believe our proposals mitigate this risk.

2.19. Our proposal is not a rolling 15-year repair programme but rather a framework for the funding of Established Deficits that makes it clear our commitment is an enduring one.

2.20. We would only expect to provide for a material increase in the pre-existing annual level of deficit funding by consumers either if such an increase is necessary to ensure the established deficit can be funded within 15 years of the review date or if the NWO provides reasonable evidence that it is in the consumer interest to fund the established deficit over a shorter period. What this means is that we would not normally insist on reductions in the current funding rate. Even if the deficit valuation is less than anticipated, we would look to the NWO to be guided by its responsibilities towards consumers when it discusses with trustees whether to shorten the repair programme, so it could continue at the current annual funding rate, or reduce the annual funding rate.

2.21. An NWO has proposed to us that alternative funding mechanisms such as asset backed contributions (ABCs) may allow a funding period to be extended beyond 15 years. Our proposal to allow funding periods to vary from their current 15-year period provides opportunities for such funding mechanisms to be used.

Future focus

2.22. In chapter 3 of the consultation we described several issues related to the reasonableness reviews. The current focus is narrow and raises expectations that we might penalise NWOs for things outside of their control. We proposed that future reasonableness reviews should reflect areas that are within the influence of NWOs and are of value to consumers. We wish to see NWOs have an interest in and are accountable for pursuing initiatives that represent best practice in other private sector contexts.

2.23. We believe that benchmarking actuarial assumptions would encourage a herd mentality and provide incentives for actuarial assumptions to cluster. We are less concerned about actuarial assumptions per se, than we are about ensuring that NWOs are able to represent the interests of consumers when they participate in scheme governance. We proposed that our reasonableness reviews would focus on NWO behaviour that affects consumers but not on adverse outcomes resulting from decisions that were reasonably made to protect the consumer interest.

2.24. We asked if you agree with our suggested future focus for the reasonableness review and what else it should consider. We also asked for your views on incentives and penalties and on the scope for benefits changes and liability management and how we could support such initiatives.

Responses

2.25. Respondents generally agreed that the focus of the reasonableness reviews should reflect those areas that are within the influence of NWOs. Although there is general agreement that the review should take a holistic approach some respondents suggested that consumer interest should not feature as part of the review. Several respondents sought further clarity as to the proposed scope of future reasonableness reviews and the impact on revenue settlements in price controls. Suggestions for areas to be included in the reasonableness review included consideration of the post-retirement discount rate, the long-term risk and return strategy and the scope for flexibility.

2.26. Respondents generally felt that the scope for benefits and liability management is limited due to the current legal protections in place, rules governing changes to benefits, potentially low take-up, small gains relative to the costs involved, reputational risk, future legal challenges and the potential for industrial action. Some felt that Ofgem could incentivise liability management although others disagreed. They generally agreed that a focus on administration costs is inappropriate because any net savings are likely to be very small and that the current RIIO framework provides sufficient incentives to keep costs down.

2.27. Many respondents sought further clarification as to how an incentives and penalties framework would work and under what criteria they would be measured. Several respondents consider the introduction of incentives and penalties as inappropriate as they felt that the price control framework was sufficient to deliver the best outcome for consumers. One suggestion was to provide incentives for an accelerated deficit recovery programme and another was to introduce ‘special measures’ which may involve Ofgem’s and/or the Pensions Regulator’s scrutiny.

2.28. Some respondents suggested that a clear statement from Ofgem setting out expectations for the NWOs to make changes in line with pensions elsewhere would help convince stakeholders that they are not necessarily a special case.

Our position

2.29. We maintain our position that consumers' interests should be at the heart of the review. We do not agree with the assertion made by some trustees that such interests should not form part of the review, and our dialogue with the Pensions Regulator encourages us that trustees should be cognisant of a NWO's responsibilities towards consumers, both existing and future consumers.

2.30. We welcome the general support for several proposed changes to the focus of the reasonableness reviews, notably our move away from benchmarking, penalties and incentives. Although we recognise that the scope for benefits and liability management is limited by existing legal protections we are open to the possibility that there may still be some opportunities here if it emerges that companies are significantly out of step with initiatives adopted by pension schemes in the non-regulated sector. We will continue to encourage NWOs to actively pursue benefits and liability management exercises insofar as they can be demonstrated to be in the interests of consumers.

2.31. We believe it would generally be inappropriate for us to penalise NWOs for not taking up liability management initiatives unless we have specified in advance, and consulted on, criteria for identifying such potential actions.

2.32. We are open to the suggestion that Ofgem could support companies' studies to evaluate the viability of benefit and liability management exercises. We welcome evidence to support the scope and need for such support from us and, in particular, how this can be demonstrated to be in the interests of consumers.

Scheme approach to risk

2.33. In Chapter 4 of the consultation we reaffirmed our position that risk management is an area which is most appropriately considered by trustees and employer sponsors. Although moves towards de-risking are appropriate for maturing schemes we expect the NWOs to consider the costs and to show that their targeted levels of risk are set at a level they believe is appropriate for consumers. We would not, however, judge the outcomes of de-risking with the benefit of hindsight.

2.34. We asked how you believe the NWOs should approach setting risk levels and whether you agree with our comments on de-risking or whether a different or more prescriptive approach is needed.

Responses

2.35. Most respondents agreed that risk management is a matter for employer sponsors and trustees and that de-risking is an appropriate response as schemes mature. They also welcomed our positon that outcomes will not be judged with the benefit of hindsight. Many respondents, however, stated that balancing risk with consumer interest is a matter of judgement and complex, and engagement with consumers in this regard is likely to be inconclusive. Trustees took the position that de-risking is in the consumer interest in that it reduced volatility and the probability of large future deficits. Consumer interest being similar to shareholder interest was suggested as an alternative approach.

2.36. There was general agreement that there is no need for a more prescriptive approach to de-risking but some felt that Ofgem could offer guidance or appoint professional advisors to consider the customer position.

Our position

2.37. We maintain that risk management is a matter for the employer sponsors and the trustees. We appreciate that this is a complex area and determining the level of risk that is appropriate for consumers may not be easy. We believe that the NWOs would be able to consider the consumer interest in their approach to risk and we encourage NWOs to engage actively with academics, consumer representatives and others to inform their thinking. We do not, however, believe our role is to provide guidance to the NWOs and the trustees as to the appropriate level of risk. We agree that a more prescriptive approach is not required. We believe it is inappropriate to assume that de-risking is necessarily in the consumer interest. We also believe it is inappropriate to judge the wisdom of any risk strategy on the basis of outcomes.

Surpluses

2.38. In chapter 5 of the consultation we highlighted our concerns over the possibility of stranded surpluses. Although consumers stand behind the deficit they may not be in a position to benefit from a surplus. While there remain active members, there is scope for NWOs to benefit from any surplus if they can agree with trustees that ongoing pension contributions can be reduced. We will be looking for NWOs to demonstrate measures they are taking to minimise the risk of a stranded surplus. Alternative funding arrangements may reduce the likelihood of stranded surpluses. Surpluses could be used to fund further de-risking or provide benefits for existing members, but this would not necessarily be in the interest of consumers.

2.39. We asked you what you believe to be the likelihood of a stranded surplus occurring and what action we could take if it did occur. We also asked for your opinions as to what formal policies on alternative funding may be required and if our existing pension allowance framework provides sufficient support for alternative funding arrangements.

Responses

2.40. The valuation method for defining a surplus was questioned by most respondents. Many respondents felt that the buy-out value should be the basis of defining a surplus on the grounds that as schemes approached closure the trustees would seek to close through a buy-out. On this basis the probability of a surplus occurring is very small. If measured on a technical provisions basis the probability of a surplus occurring is greater but would still be low as schemes would de-risk as the deficit reduces.

2.41. There were mixed responses as to how we should respond to a stranded surplus. Several respondents suggested that our actions should depend on how the surplus came about. They did not believe that penalties should be applied if the surplus was due to exceptional market conditions but may be appropriate if due to mismanagement. Some respondents agreed that surpluses should be returned to consumers although opinions differed as to how this should happen. Some suggested a legislative approach allowing funds to be returned to consumers (without tax penalties). Others suggested the surplus could be used for further de-risking, contribution holidays and funding early retirement deficiency costs contributions. Some maintained that the current rules require surpluses to be returned to the NWOs.

2.42. Although respondents generally felt that alternative funding arrangements may be appropriate they were concerned as to how the costs would be recovered under the existing framework. There was little support for a formal policy but enthusiasm for guidance setting out how Ofgem would treat different types of alternative funding arrangements, including licence changes where necessary.

Our position

2.43. We accept that the probability of a true stranded surplus occurring may be remote and if it was to occur it is unlikely to be in the short term. However, to the extent that consumers are underwriting the downsides, and especially if we provide for more flexible funding arrangements, it becomes important that we protect their interests in the upsides. In particular, it becomes important for us to ensure there are:

(a) Mechanisms to ensure consumers would benefit, in a symmetrical way, when it is possible to reduce surpluses through contribution holidays

(b) Encouragement and where necessary proportionate incentives on companies to avoid the risk of un-recoverable over-funding, sub-optimal de-risking and unnecessary benefit increases for members.

2.44. Consumers stand behind the deficit and it is right that they should be protected from over-funding. We therefore look to NWOs to minimise the risk of an unrecoverable surplus occurring, and to ensure they are proportionately incentivised to do so. We do not believe that using stranded surpluses for further de-risking and funding early retirement deficiency costs contributions would necessarily be in the best interests of consumers. NWOs should be aware that the logic of our commitment means that they would naturally be exposed to any material risk of unrecoverable over-funding.

2.45. We are open to the use of alternative funding mechanisms where they can be considered to be in the best interests of consumers. We acknowledge concerns about associated costs and we will consider the recovery of costs for these and other initiatives if they can be demonstrated to be necessary and in the consumer interest. We also believe that a prescriptive approach to alternative funding arrangements may not be necessary. One mechanism based upon asset backed contributions (ABCs) has been proposed as means of providing extended established deficit repayment periods but at the same time provides comfort to trustees.

Trustee role and the Pensions Regulator's expectations

2.46. In chapter 6 we described the role of trustees and the Pensions Regulator's expectations, in particular the Pensions Regulator's code of practice (no. 3) on funding defined benefits (2014). The code encourages trustees and employers to work together to strike the right balance between the needs of the scheme and those of the employer. The Pensions Regulator expects trustees should recognise that part of the NWO's considerations for risk tolerance, risk-taking, and for its long-term aims will include its duty to consider the needs of consumers. Conversely the Pensions Regulator expects the NWO should recognise that the trustees' considerations will be based on the needs of the scheme. The employer covenant review is one of the most important factors that trustees should consider. It will take into consideration any price control and ring fencing arrangements that the employer is subject to and guides the level of risk that it may be appropriate for trustees to accept.

2.47. Although we recognise that trustees have duties towards scheme members rather than consumers our aim is to ensure that the consumer interest is given due consideration. We believe the funding code of practice is compatible with our ring-fencing protections and the clearer funding commitment allowing trustees to accommodate wider aims that are relevant to the needs of the employer and consumers. We will continue to work with the Pensions Regulator to enable us to best communicate how our discrete, yet compatible, objectives can be accommodated by those we regulate.

2.48. We asked if you agree with our description of the trustees' role and whether you consider our approach and that of the Pensions Regulator are sufficiently consistent.

Responses

2.49. The respondents generally agreed that the duty of trustees is to their members and not consumers. Several trustees did not agree that taking into account the future growth of the employer can be translated into consideration of consumer interests. Many respondents also challenged the view that a strong covenant leads to a longer recovery plan. Some suggested that we have misinterpreted the Pensions Regulator's guidance by not giving sufficient weight to long term risk of regulatory or political interference that could influence covenant strength.

2.50. The respondents generally felt that the positions of the Pensions Regulator and Ofgem are not sufficiently aligned. They would welcome joint guidance from Ofgem and the Pensions Regulator setting out their expectations and, in particular, the Pensions Regulator's position on regulated monopolies.

Our position

2.51. Since the consultation we and the Pensions Regulator attended a meeting with the Energy Networks Association (ENA) on 11 August 2015. The Pensions Regulator followed up this meeting with a letter to the ENA (12 October 2015) stating:

'We recognise the different objectives of the two regulators here: Ofgem to ensure consumers are protected and the Pensions Regulator ("TPR") to ensure pensions member benefits are protected. However, we believe that the two approaches can be compatible. TPR's approach to encourage trustees and employees to work together to ensure risks in pensions schemes are well managed can accommodate needs of network employers incentivised by Ofgem incentivising to take consumer interests into account. And Ofgem's approach does not preclude trustees acting in members' best interests.'

We believe that this statement adequately sets out the position of the Pensions Regulator and that it is aligned with our position.

Regulatory corporate governance

2.52. In chapter 7 we described the new RIIO accounts Statement of Regulatory Corporate Governance. This would include a requirement for NWOs (but not the trustees) to account to their stakeholders for their part in the governance of pension schemes and how they have protected the interests of consumers. We believe that this should encourage NWOs to engage constructively on behalf of consumers in pension scheme governance.

2.53. We asked for your comments on our proposal to include pensions governance in the Statement of Regulatory Corporate Governance and if you believe it will effectively influence NWO behaviour.

Responses

2.54. There were no significant objections to the proposal although most respondents stated that it is unlikely to have a material impact on NWO behaviour and that the current arrangements are sufficient. Some suggested that incentives or changes to the reasonableness review would have a greater positive impact.

2.55. Some pointed out that the trustees may not always release information for the governance statement, eg information that, if released, could prejudice their ability to negotiate on contributions or benefits.

2.56. Several respondents sought further clarification as to reporting requirements and in particular the expected level of NWO accountability.

Our position

2.57. We recognise that a governance-based approach may have a less direct influence on NWO behaviour but we believe a reliance on financial rewards and penalties for the complexities of pension liability management is more likely to be counter-productive for consumers. We also recognise that there may be an additional administrative burden involved in reporting on pensions governance but this is likely to be small relative to the potential benefits to consumers and other stakeholders.

We therefore maintain that the governance of pension schemes should be covered in Statements of Regulatory Corporate Governance, which we intend to introduce with RIIO Accounts in due course.[11]

[11] We have consulted on implementation of RIIO Accounts for NWOs to report on regulatory years ending 31 March 2017.

3. Our developed proposals

3.1. As we explain in Chapter 2, we have considered the responses to our first consultation paper and drawn our broad conclusions. We have in particular recognised the need to be specific about our proposals before we reach a final decision so that interested parties have a further opportunity to comment.

3.2. Accordingly, we set out our specific proposals as proposed revisions to three documents that are central to the way we treat pensions costs within our RIIO price controls. These are:

- revisions to the statement of guidance on our pensions principles that we refer to when we conduct a price control review (the principles themselves remain unchanged)

- significant changes to the chapter in the financial handbook that governs the treatment of pensions costs during a price control period, and

- consequential revisions to the Pension Deficit Allocation Methodology.

3.3. We set out our proposed revised guidance on our pensions principles in Appendix 1. We do not propose changing the principles themselves, but the revised guidance would:

- clarify our commitment in those principles to the funding of any Established Deficit,

- point to improved flexibility around the timescale of funding, and

- reflect our clearer understanding of the respective roles and responsibilities of employers and pension fund trustees.

3.4. We set out our proposed revised financial handbook chapter, taking RIIO-ED1 as an example, in Appendix 2. We propose to put these revisions, and equivalent revisions for the other RIIO sectors, into effect in advance of the next reasonableness review. We expect to undertake the next reasonableness review in 2017 informed by actuarial valuations as at 31 March 2016.

Proposed approach for revising Pension Scheme Established Deficit repair allowances (EDE and SOEDE)

Aspects of the methodology that would not change

3.5. The revised approach we are proposing for determining revisions to Pension Scheme Established Deficit repair allowances (EDE and SOEDE[12] values) would still be based around the Annual Iteration Processes for Price Control Financial Models and the triennial scheme valuation cycles referred to in chapter 3 of each of the RIIO-1 Price Control Financial Handbooks.[13]

3.6. The Pension Scheme Established Deficit value would also be determined, as required, in the same way as at present.

Changes to the determination of allowances and repair periods

3.7. At present, in simple terms, to derive a revised Base Annual PSED Allowance, we divide the Pension Scheme Established Deficit into the number of remaining years of the fixed 15-year repair period. Similarly, any adjustment amounts relating to the licensee's payment history levels (versus allowances) and Reasonableness Reviews are divided into the number of remaining years of the fixed 15-year repair period and added to the base annual allowance to derive a revised total annual allowance (EDE value).

3.8. Under our proposed new approach, the fixed 15-year repair period would be dispensed with. Instead, after each triennial valuation, the methodology would provide for the calculation of:

(a) an indicative further PSED repair period, and

(b) an indicative base annual PSED repair allowance.

3.9. The indicative further PSED repair period would be derived as a number of years, being the lower of:

(a) the PSED divided by the existing EDE value, and

(b) 15.

An illustration of the calculation (including a time value of money factor) is shown in paragraph 3.29 of the illustrative drafting in Appendix 2.

3.10. The indicative Base Annual PSED Allowance is then derived by apportioning the Pension Scheme Established Deficit across the indicative further

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[12] SOEDE values relate to the System Operator activities of National Grid Electricity Transmission plc and National Grid Gas plc (with respect to the national transmission system)

[13] Our illustrative drafting at Appendix 2 is based on the RIIO-ED1 Price Control Financial Handbook applicable to electricity distribution licensees, but the proposed changes would be applicable to all of the RIIO price controls.

PSED repair period, taking into account a time value of money factor. An illustration of the calculation is shown in paragraph 3.31 of the illustrative drafting in Appendix 2.

3.11. Under our proposals, the NWO would submit its calculation of the indicative values to Ofgem alongside its Pension Deficit Allocation Methodology and PSED information. However, the licensee would be able to propose that a different Base Annual PSED Allowance (and consequently a different further PSED repair period) should be used, if it can explain why that would appropriately protect the interests of consumers. The values to be used (indicative values or values proposed by the NWO) would still be determined by us, but we would expect to use values proposed by the NWO (if applicable), unless the case for protecting the interests of consumers had not been made.

Asset backed funding arrangements

3.12. Our proposed approach also addresses the possible use of asset backed funding arrangements by NWOs in two respects (see paragraphs 3.11 to 3.14 of the illustrative drafting in Appendix 2).

3.13. Firstly, we acknowledge that such arrangements might help to protect the interests of consumers and might therefore be relevant to proposals for different Base Annual PSED Allowances and their corresponding repair periods.

3.14. Secondly, we make clear that allowances are given for PSED repair and not for funding asset backed arrangements per se. Accordingly, for the purpose of over/under payment versus allowance adjustments, we specify that it is the amount actually received by the pension scheme that is taken into account rather than the amount paid by the NWO into an intervening funding arrangement.

Payment history adjustments

3.15. Under our proposed approach, payments history adjustments would be valued in the same way as at present, except that we believe they should account for pension contribution holidays that are attributable to an established surplus (see paragraphs 3.27 and 3.28 below). Our proposed revisions to the financial handbooks (Appendix 2) would allow for payments history adjustments to be spread across a period designed to avoid undue burden or benefit for separate generations of consumers rather than the remainder of the fixed 15-year repair period.

3.16. We would expect, given the NWO's involvement in the setting of the Base Annual PSED Allowance and further PSED repair period under our proposed approach, that there should be fewer instances of over/under payments between triennial valuation cycles.

Reasonableness review

3.17. We are proposing that the Reasonableness Review arrangements included in the PSED methodology should be simplified and refined.

Current arrangement

3.18. At present, the Reasonableness Review comprises:

(a) the commissioning of a report by Ofgem on the costs associated with the NWO's Pension Scheme Established deficit

(b) a review by Ofgem of the report referred to in subparagraph (a)

(c) the possible introduction/continuation/cessation of adjustment factors for each NWO affecting:

i. the determination of the PSED, and

ii. EDE values.

3.19. The review referred to in paragraph 3.18 is to consider whether the NWO is an outlier with regard to pension deficit costs in a material respect and that position is:

(a) to the detriment of consumers, and

(b) reasonably attributable to the licensee, recognising the responsibilities and independence of pension scheme trustees.

3.20. The substance of our review and of the report we commissioned was to monitor the actuarial valuations and governance of pension schemes. The review would assess any need to adjust deficit repair allowances if we believed that valuations were not reasonable. Because of the time needed to obtain the report and consider its findings with respect to cost levels, Reasonableness Reviews under the current arrangement might not be completed in time for the scheduled revisions of EDE values, potentially requiring ad hoc additional revisions.

Proposed arrangement

3.21. Under our proposed approach, rather than focusing on valuation assumptions, we would review the information provided by the NWO with its Scheme Valuation Data Set to gauge how the NWO had:

(a) engaged with pension scheme trustees and managers to advocate for the interest of consumers with respect to the PSED, and

(b) followed good practice in promoting consumer interests with respect to the PSED.

3.22. We would only introduce or continue an adjustment factor if necessary to disallow excess costs arising from a material failure of stewardship with regard to Principle 3.

3.23. We would expect each Reasonableness Review to be completed by 30 November in the year concerned, in time for the scheduled revisions of EDE values.

Scheme surpluses

3.24. One of the concerns about the existing PSED allowances methodology is that a mechanical re-setting of allowance levels to target a zero deficit at a fixed point in time could lead to:

(a) undue volatility in allowance levels (if, for example, the PSED rose sharply towards the end of the fixed repair period), and

(b) a higher risk of surpluses arising if the existence of a fixed repair period encouraged more prudent PSED valuations up to the end of the period, surpluses which may not be readily returned to consumers who funded them.

3.25. As noted above, the limitations associated with the current approach could be particularly pronounced in the last few years of the fixed 15-year repair period. Our proposed new approach should help to mitigate these risks by providing for more flexible funding arrangements.

3.26. Our proposed approach would also reiterate our commitment to fund an Established Deficit even if, for an interim period, there were to be a surplus position (see paragraph 3.9 in Appendix 2).

3.27. We have also recognised that our current arrangements do not provide for an appropriate return of funding to consumers if an established surplus arises and consequently permits the employer to reduce the pension contributions it makes for its active members. This is sometimes called a contribution holiday. We consider it appropriate and necessary to treat any reduction in ongoing pension contributions that is attributable to the presence of an established surplus (which would have been funded by consumers) as a return to consumers of past funding of the PSED.

3.28. We set out arrangements for dealing with any pension contribution holiday in the proposed amendments to the financial handbooks (Appendix 2, see paragraph 3.35 and the definition of D_y in paragraph 3.37 in Appendix 2). We recognise the prospect of contribution holidays arising within the current control periods seems remote but we believe this arrangement is necessary to reassure consumers that their interests are properly protected.

Treatment of specified external initiative costs

3.29. We acknowledge that our funding commitment means that NWOs do not have a direct economic incentive in minimising scheme costs on behalf of consumers. Nevertheless, the reforms we are consulting on in this document aim to ensure that NWOs are able to play a positive role in protecting consumer interests and advocating on their behalf. We know that NWOs can be effective advocates for consumers and can recognise the underlying and long term benefits for their regulated business, and consequently for their investors, in taking their responsibilities seriously.

3.30. For these reasons, we do not believe that NWOs should routinely need specific funding for sponsoring initiatives that are designed to benefit consumers. These might include the development of alternative funding mechanisms and benefit management initiatives, initiatives which may involve financial costs and business risks.

3.31. However, we anticipate that it may be appropriate to allow for funding, on an exceptional basis (through the D_y term referred to in paragraph 3.37 in Appendix 2), for major initiatives that are capable of generating material benefits for consumers. We would need to be satisfied that the initiative has a reasonable expectation of generating benefits for consumers through better management of the cost of funding established deficits and that it is proportionate to recognise the external advisory costs incurred in developing the initiative as part of the costs of funding an established deficit. For funding to be proportionate, the advisory fees would be of a nature and scale that had not been anticipated at the last price control review.

PCFM Variable Values

3.32. EDE values, once determined under the proposed new methodology, would be directed for use in the Annual Iteration Processes for Price Control Financial Models in the same way as at present.

Revisions to the Pensions Deficit Allocation Methodology

3.33. We propose a revision of the Pensions Deficit Allocation Methodology to ensure it is consistent with the arrangements we describe in paragraph 3.28 above.

3.34. We propose to revise how the value of assets attributed to the Post Cut-Off Date Notional Sub-Fund is calculated. The revision should ensure there is symmetry in the treatment of

(a) Increased pension contributions as a result of an intention to repair a deficit

(b) Reduced pension contributions as a result of an intention to reduce a surplus.

3.35. The calculation of the value of assets attributed to the Post Cut-Off Date Notional Sub-Fund is set out in a table within paragraph 5.2 of the Pension Scheme Allocation Methodology. The calculation makes an adjustment for 3.34(a) above only in respect of the deficit attributable to post-cut-off pensionable service (line d in the calculation). However, because the calculation includes employer contributions paid towards future benefit accrual since last valuation (line a in the calculation), it incorporates an adjustment for <u>all</u> of 3.34(b). To make the calculation symmetrical, it is therefore necessary to amend it.

3.36. Reflecting the logic in paragraph 3.35, we could make the following amendment:

Where the current calculation states:

plus	Employer contributions paid towards future benefit accrual since last Valuation

We could replace it with:

plus	Value of future benefit accrual since last Valuation
plus or minus	Differences between employer contributions paid towards future benefit accrual since last Valuation and the value of future benefit accrual since last Valuation arising because of short term timing differences in contribution payments (ie excluding differences relating to deficits and surpluses)
minus	The portion of differences between employer contributions paid towards future benefit accrual since last Valuation and the value of future benefit accrual since last Valuation arising because of a surplus attributable to post Cut-Off Date pensionable service

3.37. Rather than amending the calculation in line with the suggestion in paragraph 3.36, we believe it is equivalent but simpler to make the amendment in a way that adds only one new component to the calculation, as follows:

plus	Employer contributions paid towards future benefit accrual since last Valuation
plus	The portion of differences between employer contributions paid towards future benefit accrual since last Valuation and the value of future benefit accrual since last Valuation arising because of a surplus attributable to pre Cut-Off Date pensionable service

3.38. We therefore propose to amend the calculation in the way we describe in paragraph 3.37.

Appendices

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Appendix 1 – Proposed revised guidance note on price control pension principles under RIIO

We set out in this Appendix our proposed changes to the text of our guidance on price control pension principles under RIIO, which will be subject to our review of responses to this consultation. We do not propose any changes to the principles themselves. The guidance notes explain how we intend to apply the principles to defined benefit pension schemes in rolling forward our RIIO price controls. We would expect to refer to this guidance in our strategy decisions at the start of our RIIO price control reviews. Consistent with our practice to date, we may refine the guidance notes at those times to take account of developments in the pension arena.

Price control pension principles under RIIO

Principle 1 - Efficient and economic employment and pension costs

Customers of network operators should expect to pay the efficient cost of providing a competitive package of pay and other benefits, including pensions, to staff of the regulated business, in line with comparative benchmarks.

1. Consumers should not be expected to pay any excess costs that are avoidable by efficient management action.

2. We will, in general, benchmark, incentivise and remunerate employment costs (including costs for pensionable service after the relevant cut-off date) as part of total expenditure. We may remunerate pension scheme administration costs and Pension Protection Fund (PPF) levies on a basis that reflects that they are partly outside the control of sponsors and trustees.

Our enduring commitment to funding the Established Deficit

3. We commit to the continuing funding of the Established Deficit by way of revenue allowances in our price controls. This commitment will apply even if there has been an interim period during which a funding surplus is reported.

4. The Established Deficit means the difference between assets and liabilities (the value of the benefits and any residual liability arising following a comprehensive pensioner buyout) attributable to pensionable service up to the dates set out below and relating to the regulated business under principle 2:

- for DNOs – 31 March 2010
- for GDNs – 31 March 2013
- for TOs/TSOs – 31 March 2012.

5. Although the Established Deficit represents a fixed obligation, its valuation is subject to change caused by exogenous factors, for example a fall in the value of stock markets or changes in longevity assumptions. Changes in the deficit may also arise from de- or re-risking or other rebalancing actions.

6. Conversely, our funding commitment does not cover any element of deficit falling outside the scope of the Established Deficit (eg non–regulated activities and bulk transferees) or the service of those employees who were or are still active in the scheme after the relevant cut-off date.

7. We would take account of any deficit funding payments that arise from service after the relevant cut-off date as part of a network operator's general expenditure and subject to the same incentive mechanisms as ongoing employment costs.

Protecting the consumer interest

8. In light of our funding commitment, we look to employers to participate in the governance of defined benefit pension schemes with the aim of protecting the interests of the consumers who are exposed to any Established Deficit, in balance with the interest of shareholders who would be underwriting any remaining deficit. To this end, we would look to employers to inform investment, benefit and funding strategies with objective and where possible evidence-based insights into the interests of consumers, recognising that tomorrow's consumers are as relevant as today's. We look to employers to report transparently on their participation in the governance of these schemes.

Established Deficit revaluations and Established Deficit repair funding periods

9. The Established Deficit at any triennial review should be funded over a reasonable period thereafter, taking into account the strength of the employer's covenant and the need to avoid unnecessarily high annual cost burdens for consumers. A funding period may be initiated, extended or shortened in light of a revaluation. We would only expect to provide for a material increase in the pre-existing annual level of deficit funding by consumers if:

a) such an increase were necessary to ensure the Established Deficit, together with any payment history adjustment, could be funded within 15 years of the review date, or

b) if the employer were to provide reasonable evidence that it was in the consumer interest to fund the Established Deficit and any true-up value over a shorter period.

10. We would judge materiality in the context of the overall price control.

11. Provided we are satisfied that the triennial revaluation of the Established Deficit has been carried out by an appropriately appointed person in accordance with actuarial best practice, the pensions deficit allocation methodology and these principles, we would expect to implement a funding profile proposed by the network

operator, or otherwise determined by us, that meets the criteria described in paragraph 9.

Surpluses and de-risking

12. Network operators' defined benefit schemes are generally closed mature schemes with the majority of members either pensioners or deferred pensioners. As such, we understand that they are generally looking to match their assets and revenues to their liabilities. In doing this, their investment strategies may move from riskier to less risky assets, and they may employ hedging, buy-ins, buyouts and other rebalancing and risk-reducing strategies. In considering these options, we would look to employers to take account of the interests of consumers, taking advice from experts as appropriate.

13. Sponsors may also seek to use asset-backed funding mechanisms or other alternative funding solutions to mitigate funding increases in or to permit reductions in annual deficit funding costs, or to help minimise the risk of stranded surpluses. We would expect the network operator to demonstrate at inception the expected benefits to consumers.

14. We believe there should be symmetry in the treatment for funding of deficits and any use of surpluses. To the extent that consumers are funding deficits, we would expect consumers to receive any benefit that arises in the event that those schemes turn into surplus. This is because an established surplus would indicate that more had been paid into a scheme (by consumers) than, in retrospect, was necessary. To ensure overall consumers are paying no more than an efficient cost, we propose to treat any contribution holiday for ongoing pensions that is made possible because of an Established Surplus as negative PSED funding. Although we understand that the risk of any trapped surplus (a surplus that cannot be resolved through contribution holidays) is remote, we expect network operators to minimise the likelihood of any trapped surplus arising.

Principle 2 - Attributable regulated fraction only

Liabilities in respect of the provision of pension benefits that do not relate to the regulated business should not be taken into account in assessing the efficient level of costs for which allowance is made in a price control.

15. It is for shareholders, rather than consumers of the regulated services, to fund liabilities associated with businesses carried on by the wider non-regulated group, ie activities not remunerated by network operators' price control allowed revenues. This includes businesses that were formerly carried on by the same ownership group and have been sold, separated and/or ceased to be subject to the main price control. In principle, this may include costs related to self-financing excluded services, metering, and de minimis activities of the network company and of unregulated businesses in the same scheme in the context of a transportation and/or distribution price control. For the purposes of the regulatory fraction and the pension deficit allocation methodology, these are collectively labelled 'non-regulated activities'. These will have been dealt with on a case-by-case basis, as in some cases the costs of such businesses or activities are not readily separable from the regulated business.

16. The regulatory fraction determined in setting allowances should be updated when there have been structural changes to a scheme, including bulk transfers, or other relevant movements including cash funding by sponsors to any previously unfunded Early Retirement Deficiency Contributions.

Principle 3 - Stewardship - ante/post investment

Adjustments may be necessary to ensure that the costs for which allowance is made do not include excess costs arising from a material failure of stewardship.

17. We will 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. Examples would include recklessness, negligence, fraud or breach of fiduciary duty towards consumers.

Principle 4 - Actuarial valuation/scheme specific funding

Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice.

18. We expect the level of scheme funding to be assessed on the basis of forward looking assumptions regarding long-run investment returns and other key variables by appropriately appointed actuaries. Network operators are required to report the results of triennial valuations to enable the resetting of and the true up of Established Deficit funding allowances.

Principle 5 - Under funding/over funding

In principle, each price control should make allowance for the ex ante cost of providing pension benefits accruing during the period of the control, and similarly for any increase or decrease in the cost of providing benefits accrued in earlier periods resulting from changes in the ex ante assumptions on which these were estimated on a case-by-case basis.

19. Typically, pension schemes undertake full actuarial valuations triennially, whereas, RIIO price controls are set for periods of eight years. RIIO price controls therefore provide for adjustments to allowance levels for Established Deficit repair under methodologies set out in the Price Control Financial Handbooks which form part of the charge restrictions conditions in the respective licences.

20. Adjustments generally take place in the calendar year following a triennial actuarial valuation and reset allowances for the regulatory year starting in the year following that. Our review work, under the methodologies, will focus on ensuring compliance with the pension deficit allocation methodology and with these principles.

21. Any under- or over-funding of the Established Deficit relative to the allowance in the previous three years will be trued up on an NPV-neutral basis, using the same discount rates as used for spreading the ex ante deficit allowances. The cumulative true-up value calculated in this way will be taken into account in the funding profile determined in accordance with paragraph 11.

Principle 6 - Severance - early retirement deficiency contributions (ERDCs)

Companies will also be expected to absorb any increase (and may retain the benefit of any decrease) in the cost of providing enhanced pension benefits granted under severance arrangements which have not been fully matched by increased contributions.

22. Since 31 March 2004, ERDCs, whether partially funded or totally unfunded, are a matter solely for shareholders.

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

24. For this purpose, it is necessary to roll forward the previously agreed amounts of ERDCs arising prior to 1 April 2004. The methodology and the mechanisms are set out in the pension deficit allocation methodology.

Appendix 2 - Proposed revised financial handbook chapter (ED1 example)

For the purposes of this consultation we set out below how we propose to modify Pension Scheme Established Deficit methodology. The drafting below is based on chapter 3 of the RIIO-ED1 Price Control Financial handbook that forms part of the price control conditions in electricity distribution licences. Our proposals would involve similar modifications to chapter 3 in the Price Control Financial Handbooks for RIIO-T1 (gas and electricity transmission) and RIIO-GD1 (gas distribution). The existing Price Control Financial Handbooks can be accessed via the PCFM page on the Ofgem website:

https://www.ofgem.gov.uk/network-regulation-riio-model/price-controls-financial-model-pcfm

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

Section 1 - Introduction

3.1 The Opening Base Revenue Allowances ('PU' values) for the licensee set down in the table at Appendix 1 to CRC 2A (Restriction of Allowed Distribution Network Revenue) include allowances for Pension Scheme Established Deficit (PSED) repair expenditure for each Regulatory Year of the Price Control Period.[14]

3.2 These allowances are represented by the opening EDE values[15] held in the PCFM Variable Values Table for the licensee contained in the ED1 Price Control Financial Model (PCFM) and are expressed in 2012/13 prices. Opening EDE values are based on modelling assumptions and parameters applicable at the outset of the Price Control Period. At that time, the PSED was projected to be fully repaired by 31 March 2025.

3.3 The allowance levels will be updated during the Price Control Period by revising EDE values for the purpose of the Annual Iteration Process for the PCFM. This chapter sets out:

- the reasons for updating allowances

[14]Ongoing Pension Service Costs (including Pension scheme administration and Pension Protection Fund (PPF) levy costs) are included as an element of labour costs in RIIO-ED1.

[15]As at 1 April 2015.

- the methodologies for determining revised EDE values
- the expected timing of revisions, and
- the effect on the licensee's allowed revenue of revising EDE values for the Annual Iteration Process.

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

3.5 The Price Control Period ends on 31 March 2023, but EDE values will be determined having regard to further PSED repair periods determined under the methodology set out in this chapter.

Price control pension principles

3.6 Ofgem's price control pension principles were specified in the Authority's final proposals for the DPCR5 Price Control[16] and also set out in:

- Appendix 7 of the Authority's Strategy decision for RIIO-ED1 - Financial issues supplementary annex (see associated document b), and
- [subject to consultation responses, in the decision document concluding this consultation],

to which reference should be made. The principles are:

Principle 1 - Efficient and Economic Employment and Pension Costs
Customers of network monopolies should expect to pay the efficient cost of providing a competitive package of pay and other benefits, including pensions, to staff of the regulated business, in line with comparative benchmarks.

Principle 2 - Attributable Regulated Fraction Only
Liabilities in respect of the provision of pension benefits that do not relate to the regulated business should not be taken into account in assessing the efficient level of costs for which allowance is made in a price control.

Principle 3 - Stewardship - Ante/Post Investment
Adjustments may be necessary to ensure that the costs for which allowance is made do not include excess costs arising from a material failure of stewardship.

Principle 4 - Actuarial Valuation/Scheme Specific Funding
Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice.

Principle 5 - Under Funding/Over Funding
In principle, each price control should make allowance for the ex ante cost of providing pension benefits accruing during the period of the control, and similarly for any increase or decrease in the cost of providing benefits accrued

[16] Electricity Distribution Price Control Review Final Proposals – Financial Methodologies

in earlier periods resulting from changes in the ex ante assumptions on which these were estimated on a case-by-case basis.

<u>Principle 6 - Severance - Early Retirement Deficiency Contributions</u>
Companies will also be expected to absorb any increase (and may retain the benefit of any decrease) in the cost of providing enhanced pension benefits granted under severance arrangements which have not been fully matched by increased contributions.

Pension Scheme Established Deficit

3.7 For the purposes of CRC 3C (Specified financial adjustments) and this chapter, the term Pension Scheme Established Deficit (PSED) means an amount derived as the value of the assets within a defined benefit pension scheme (or schemes) sponsored by the licensee, less the corresponding liabilities, where those assets and liabilities are:

- attributable to the licensee's distribution business, and
- attributable to pensionable service up to and including 31 March 2010 (the cut-off date).

3.8 The definition set out in paragraph 3.7 applies even if the value derived is a positive amount (a surplus position), in which case the PSED would be negative.

3.9 On a triennial basis (see Table 3.1) the licensee provides Ofgem 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 3.7

(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[17], and

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[17]Energy Network Operators' Price Control Pension Costs - Regulatory Instructions and Guidance: Triennial Pension Reporting Pack supplement including pension deficit allocation

(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, 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 Ofgem at the earliest opportunity.

3.14 Asset-backed funding arrangements will generally be disregarded in the determination of revised EDE values because allowances are provided for PSED repair and not to fund ancillary arrangements per se. However, such arrangements may be relevant in any proposal by the licensee of a further PSED repair period and/or EDE values that are different from indicative values ascertained under the methodology set out in Section 2 of this chapter.

Costs and adjustments outside the scope of this chapter

Pension costs for service after 31 March 2010

3.15 The following costs are dealt with as Totex expenditure in the RIIO-ED1 price control and therefore fall outside the scope of CRC 3C and this chapter:

(a) pension costs associated with employee service after the start of the Price Control Period, after adjusting for any pension contribution holidays attributable to the PSED

(b) accrued liability costs associated with employee service after the cut- off date (Pension Scheme Incremental Deficit costs), and

(c) pension scheme administration costs and Pension Protection Fund levy costs.

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methodology ("Pension RIGs")

http://www.ofgem.gov.uk/Networks/Documents1/NWO%20Triennial%20Pension%20RIGS%20supplements%20v1.0%2012Apr13.pdf

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

3.16 Under the terms of the price control that preceded the RIIO-ED1 Price Control Period (the DPCR5 Price Control), the 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:

(a) the funding of defined benefit pension schemes in respect of pensionable service that took place on or after 1 April 2010

(b) the funding of defined contribution schemes and Personal Accounts associated with Qualifying Workplace Pension Schemes under the provisions of the Pensions Act 2008, and

(c) pension administration costs.

3.17 Any outstanding adjustment in respect of the true-up described in paragraph 3.16, 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.

Section 2 – Methodology for revising PSED repair allowances

Overview

3.18 The licensee's Pension Scheme Established Deficit repair allowances (EDE) may be revised during the Price Control Period to reflect:

(a) information contained in pension scheme actuarial valuation reports provided by the licensee to Ofgem

(b) the licensee's updated PSED (defined in paragraph 3.7)

(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 Ofgem

(d) proposals made by the licensee for Base Annual PSED Allowances and payment history allowances

(e) asset-backed funding arrangements associated with proposals referred to in subparagraph (d)

(f) the outcomes of Reasonableness Reviews (see paragraph 3.47).

3.19 CRC 3C requires the Authority to determine annually whether any EDE values should be revised. However, subject to paragraph 3.20, 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 EDE values, following

Reasonableness Reviews, is set out in Table 3.2. It may, however, be necessary to revise EDE values at different times if, for example:

(a) a scheme valuation is delayed, or

(b) the completion of a Reasonableness Review (see paragraph 3.47) has been delayed.

3.20 For the avoidance of doubt, the revision of EDE values at a different time because of the delayed completion of a Reasonableness Review will not prevent the revision of EDE values on the two occasions referred to in paragraph 3.19 with respect to adjustments that can be taken into account at those times.

3.21 If any adjustments relating to the licensee's payment history for Regulatory Years up to 2014/15, were not fully taken into account in the licensee's opening EDE values, Ofgem will consider whether such adjustments should be included in proposed revisions to EDE values for the purpose of the Annual Iteration Processes that will take place by 30 November 2015 and 30 November 2016.

Table 3.1 - Expected timetable for EDE 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 EDE values
31 March 2016	7 July 2017	31 August 2017	30 November 2017 (rr = 2017/18)	30 November 2017
31 March 2019	7 July 2020	31 August 2020	30 November 2020 (rr = 2020/21)	30 November 2020
31 March 2022	7 July 2023	31 August 2023	30 November 2023 (rr = 2023/24)	see note

Note: Information relating to the defined benefit pension scheme valuation as at 31 March 2022 will be taken into account in the setting of Pension Scheme Established Deficit repair cost allowances for the RIIO-ED2 price control.

3.22 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 Ofgem's Pension Deficit Allocation Methodology.

3.23 As stated in paragraph 3.19, the Authority will direct revised EDE values at other times, if that is necessary to reflect any revised timetable of information availability or process completion. However, in those circumstances, EDE values would still be determined in a way that is consistent with the procedures set out in this chapter.

Determination of revised EDE values

3.24 Revised EDE 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.

3.25 Revised EDE values will be determined on each occasion using the process set out in Table 3.2 and explained further in paragraphs 3.26 to 3.46.

Base Annual PSED Allowances

3.26 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.

3.27 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

3.28 The indicative further PSED repair period represents a whole number of years 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 rpa, rounded up to a whole number of years, where rpa is calculated using the following formula:

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

where:

PSED is defined in paragraph 3.7, expressed in constant price terms in accordance with paragraph 3.24

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

DR is the discount rate specified in the licensee's Scheme Valuation Data Set (established in accordance with Principle 4 - see paragraph 3.6), and

EBAPA is an average of the Base Annual PSED Allowance expressed in constant price terms in accordance with paragraph 3.24 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.

3.29 For example, if the discount rate was 2%, the PSED was £1m in 2012/13 prices and the existing EDE value was £100k, then the Indicative further PSED repair period would be 12 years, being the lower of:

(a) 11.1, calculated under the formula at paragraph 3.28(a), rounded up to 12, and

(b) 15.

Indicative Base Annual PSED Allowance

3.30 The indicative amount for the Base Annual PSED Allowance, IBAPA, is ascertained using the following formula:

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

where:

rpa is the indicative further PSED repair period ascertained under paragraph 3.28, and

DR is the discount rate specified in the licensee's Scheme Valuation Data Set (established in accordance with Principle 4 - see paragraph 3.6).

3.31 For example, if the PSED was £1m in 2012/13 prices, the Indicative further PSED repair period was 12 years, and the discount rate was 2%, the indicative Base Annual PSED Allowance would be £93,626.

Proposal by the licensee

3.32 The licensee may propose allowances in line with the Indicative Base Annual PSED Allowance calculated under paragraph 3.30. The licensee should propose an alternative profile of Base Annual PSED Allowances over a repair period that may be shorter or longer than the period determined by paragraph 3.28 if it considers and provides evidence that the indicative Base Annual PSED Allowance calculated by paragraph 3.30 above either:

(a) does not fairly represent a profile of repair payments that can be agreed with the scheme trustees,

(b) following consultation with Ofgem, does not appropriately protect the interests of consumers, or

(c) is otherwise inappropriate or inequitable.

3.33 The proposal under paragraph 3.32 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

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

where:

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

$PBAPA_y$ for years rr-1 and rr are the Base Annual PSED Allowances determined by the Authority for those years, and

The proposed profile of $PBAPA_y$ fairly represents repair payments that can be agreed with the scheme trustees.

3.34 In framing its proposal under paragraph 3.32, the licensee should set out why it considers that its proposal appropriately protects the interests of consumers.

Established surpluses

3.35 In the event that the licensee enters into a programme of partial or full contribution holidays in respect of accruals of benefits for active members, consistent with price control pension Principle 1, the licensee's proposal under paragraph 3.32 should reflect the portion of any anticipated contribution holiday that would be attributable to the existence of an established surplus. Accordingly, Base Annual PSED Allowances may be negative.

Payment history allowances

3.36 The determination of revisions to EDE 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.

3.37 The cumulative payment history variance value at the end of the Reasonableness Review year, V_{rr}, is ascertained using the following formula:

$$V_{rr} = \sum_{y=pco1}^{rr} \left(\frac{(D_y - E_y)(1 - CT_y)}{(1 + f_y \cdot WACC_y)(1 - CT_{rr+1})} \prod_{t=y}^{rr} (1 + WACC_t) \right) + \frac{DP5TUV}{1 + f_{2014/15} \cdot WACC_{2014/15}} \prod_{t=2015/16}^{rr} (1 + WACC_t)$$

where:

pco1 means the first regulatory year subsequent to the cut-off date, which for DNOs is 2010/11

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

D_y means the net sum of the following, expressed in constant price terms in accordance with paragraph 3.24:

- amounts received or, in the case of D_{rr}, forecast to be received by the relevant pension scheme(s) in respect of PSED repair during the course of year y,
- less the amount by which ongoing pension contributions have been reduced on account of a PSED surplus

plus any amounts determined by Ofgem as pensions initiative development advisory fees following a review of evidence submitted by the licensee E_y means the licensee's Base Annual PSED Allowances plus payment history allowances (which may be positive or negative) for the year y, expressed in constant price terms in accordance with paragraph 3.24 (for the avoidance of doubt, Ey excludes any adjustment factor value AF)

CT_y means the actual or, in the case of CT_{rr+1}, 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

$WACC_y$ means the Vanilla Weighted Average Cost of Capital applicable to the licensee during year y, and

DP5TUV means the 2015/16 net present value of the true up cash adjustment for 2009/10 calculated for the RIIO-ED1 final determinations

$$f_y = \frac{1}{2 + WACC_y}$$

3.38 Positive components of D_y should be excluded from Totex and negative components of D_y should be included as additions to Totex.

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

$$\sum_{y \geq rr+1} \frac{PPH_y\left(1 + f_y \cdot WACC_y\right)}{\left(1 + WACC_y\right)^{y-rr}} = V_{rr}$$

$WACC_y$ means the a forecast Vanilla Weighted Average Cost of Capital applicable to the licensee during year y, which may be taken to be the same as $WACC_{rr+1}$ (which should be determined at the time of the relevant annual iteration)

If V_{rr} is material relative to the overall level of allowed revenues, the proposal should aim to avoid undue burden or undue benefit for any particular generation of consumers by providing for a reasonable smoothing of the adjustments over time

Otherwise, the proposal should aim to secure a resolution of the cumulative payment history variance over a reasonably short period.

3.40 In framing its proposal under paragraph 3.38, the licensee should set out why it considers that its proposal appropriately protects the interests of consumers.

Adjustment factors and Reasonableness Reviews

3.41 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, Ofgem will review the way in which the licensee has:

(a) formulated and justified its proposals for Base Annual PSED Allowances and Payment History Allowances

(b) engaged with pension scheme trustees and managers to advocate for the interest of consumers with respect to the PSED

(c) responded to any recommendations set out by the Authority in preceding Reasonableness Reviews

(d) otherwise followed good practice in promoting consumer interests with respect to the PSED.

3.42 The review referred to in paragraph 3.39 is termed the Reasonableness Review for the purposes of this methodology. Having completed the review, Ofgem 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) adjusting the profiles (but not the overall prospective values) of Base Annual PSED Allowances and Payment History Allowances after consultation with the licensee and giving its reasons why the licensee's proposals do not appropriately protect the interests of consumers

(c) continuing to apply, modifying the scope or modifying the effect of any existing adjustment factors affecting EDE values that were put in place following a prior Reasonableness Review, and

(d) applying any new adjustment factor under paragraph 3.43 below.

3.43 Consistent with its price control pensions Principle 3, the Authority will only apply adjustment factors referred to in paragraph 3.42(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 3.37 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

3.44 Before deciding to continue to apply an existing adjustment factor, introduce a new adjustment factor or modify the scope or effect of an existing adjustment factor, Ofgem will consult with the licensee.

3.45 After, considering any representations made by the licensee, Ofgem will:

(a) notify the licensee of its decision

(b) set out the matters, referred to in paragraph 3.43 that have led to its decision, and

(c) Set out the basis on which it considers any such adjustment factor might be discontinued at the next Reasonableness Review.

3.46 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 in promoting consumer interests with respect to the PSED, the Authority may set out a recommendation to the licensee to adopt good practice before the next reasonableness review provided:

(a) the Authority can reasonably establish that adopting good practice in response to the recommendation would be in the interest of consumers and would not disproportionately harm the licensee

(b) the Authority reasonably believes it is practical for the licensee to respond positively to the recommendation.

Section 3 – Reasonableness reviews and revising EDE values

3.47 The timetable for revising EDE 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 EDE values and for a reasonableness review

Row	Due by	Event
1	7 July	Ofgem will obtain the licensee's Scheme Valuation Data Set 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	Ofgem 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: (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 (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 (c) Explanation of how it has responded to any recommendations set out by the Authority in

Row	Due by	Event
		preceding Reasonableness Reviews.
4	31 August	The licensee will submit: (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 (b) Its proposals and supporting evidence for its proposed Base Annual PSED Allowances, $PBAPA_y$, and payment history allowances, PPH_y, under paragraphs 3.32 and 3.38
5	30 September	Ofgem will provisionally decide whether: (a) Any change should be made to the licensee's proposals for Base Annual PSED Allowances and payment history allowances for reasons anticipated in paragraph 3.42 (a) and (b) (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 3.43 (c) To set out any recommendation to the licensee to adopt good practice before the next reasonableness review under paragraph 3.46 The Authority will give notice of any such provisional decisions to the licensee, allowing 14 days for representations to be made.
6	30 November	Ofgem will complete its Reasonableness Review: (a) Determine the values $BAPA_y$, representing the Base Annual PSED Allowances, for each of the three years following the reasonableness review (b) Determine the values PH_y, representing the payment history allowances, for each of the three years following the reasonableness review (c) Determine the values AF_y, representing any adjustment factors, for each of the three years following the reasonableness review (d) Compute and direct the EDE values for each of the three years following the reasonableness review, such that: $EDE_y = BAPA_y + PH_y + AF_y$ (e) Set out any recommendation to the licensee to adopt good practice before the next reasonableness review (f) Publish a report on the reasonableness review.

Direction of revised EDE values

3.48 The Authority will direct revised EDE values by no later than 30 November in the year of a reasonableness review in accordance with the procedure set out in Part D of CRC 3C. EDE values, as revised, are included in full in recalculated base revenue figures in the PCFM under the Annual Iteration Process.

Appendix 3 – Responding to this consultation

We would like to hear the views of interested parties in relation to any of the issues set out in this document. In particular, we would like to hear from trustees and consumer representatives as well as affected NWOs.

We do not set out specific questions for this consultation but rather invite general responses to the detailed proposals in this document.

Responses should be received by 27 April 2016 and should be sent to:

Ian Rowson
RIIO Finance
9 Millbank, London, SW1P 3GE
020 3263 2786
RegFinance@ofgem.gov.uk

Unless marked confidential, we will publish responses on our website, www.ofgem.gov.uk. Respondents may request that their response is kept confidential. We shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

It would be helpful if responses could be submitted both electronically and in writing.

Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. Respondents are asked to put any confidential material in the appendices to their responses.

Next steps: Having considered the responses to this consultation, we intend to issue a decision document. Any questions on this document should, in the first instance, be directed to:

Ian Rowson
RIIO Finance
9 Millbank, London, SW1P 3GE
020 3263 2786
RegFinance@ofgem.gov.uk

Appendix 4 - Glossary

A

Allowed revenue

The maximum amount of money that a network company is allowed under its licence to earn on its regulated business and recover from customers through its use of system charges. Allowed revenue generally comprises base revenue, incentive rewards or penalties and allowances from uncertainty mechanisms.

Asset backed contributions (ABCs)

An alternative funding mechanism is a contractual funding arrangement under which an income stream is provided to a pension scheme, usually via a special purpose vehicle. The income stream is usually given a net present value by the trustees and is treated as an asset, thereby reducing or eliminating the pension scheme's deficit.

The Authority/Ofgem/GEMA

Ofgem is the Office of Gas and Electricity Markets, which supports the Gas and Electricity Markets Authority (GEMA), the body established by section 1 of the Utilities Act 2000 to regulate the gas and electricity markets in Great Britain.

B

Base revenue

The core amount of money that a network company is allowed to earn on its regulated business in order to recover the efficient costs of carrying out its activities. Base revenue includes allowances for operating costs, the return of capital (depreciation), return on capital, tax, pension deficit repair and any adjustments to previous allowances. The base revenue allowance forms a part of a NWO's allowed revenue.

C

Consumer

In considering consumers in the regulatory framework we consider users of network services (for example generators, shippers) as well as domestic and business end consumers, and their representatives.

Cut-off date

31 March 2010 for DNOs, 31 March 2013 for GDNs and 31 March 2012 for TOs/TSOs.

D

Defined benefit (DB) pension scheme

A pension scheme where the benefits that accrue to members are based on a set formula which generally takes into account the members' salaries and years of accrued service in the scheme.

Distribution Network Operators (DNOs)

NWOs that hold electricity distribution licences.

E

Established Deficit

The difference between assets and liabilities, determined at any point in time, attributable to pensionable service up to the end of the respective Cut-Off Dates and relating to Regulated Business Activities under Pension Principle 2. The term applies equally if there is a subsequent surplus.

F

Financial Handbook

The Price Control Financial Handbook that forms part of the price control conditions in NWO licences.

G

Gas Distribution Networks (GDNs)

NWOs that hold gas transporter licences and operate the distribution infrastructure that transports gas from the National Transmission System to final consumers and to connected system exit points.

N

Network Operators (NWOs)

Companies which own and operate the gas and electricity networks in Great Britain. This includes DNOs, GDNs and TOs/TSOs. Generally in this document, NWOs refer to network operators that are subject to RIIO price controls.

Non-Regulated Business Activities

Activities which are not remunerated by allowed revenues including activities that are not distribution or transmission business activities of the licensee and activities of co-sponsoring affiliates of the licensee which are not NWOs.

P

Pension Principles

The price control Pension Principles and supporting guidance notes that Ofgem maintains, periodically publishes and refers to in its RIIO price control reviews and pension reasonableness reviews.

Pensions Reasonableness Reviews

Ofgem's reviews of Pension Scheme Established Deficit revenue allowances, which it carries out in accordance with Chapter 3 of NWOs' financial handbook.

Price control (control)

The control developed by the regulator to set targets and allowed revenues for network companies. The characteristics and mechanisms of this price control are developed by the regulator in the price control review period depending on network company performance over the last control period and predicted expenditure in the next.

R

RIIO (Revenue = Incentives + Innovation + Outputs)

Ofgem's price control regulatory framework, stemming from the conclusions in 2010 of Ofgem's RPI-X@20 project. It places emphasis on incentives to drive the innovation and outputs needed to deliver a sustainable energy network at value for money to existing and future consumers.

T

Transmission Owners and Transmission System Operators (TOs/TSOs)

NWOs that hold gas or electricity transmission licenses.

Triennial Valuation

An actuarial valuation of a pension scheme which has been carried out to meet the requirements of Chapter 224(2)(a) of the Pensions Act 2004 and which details in a written report, prepared and signed by the Scheme Actuary, the value of the scheme's assets and Technical Provisions. Actuarial valuations are usually produced triennially.

Appendix 5 - Feedback questionnaire

Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

Please send any feedback comments to:

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