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Network operators and any other
interested parties.

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Date: 7 April 2017

Dear Colleagues,

Decision on Ofgem's policy for funding Pension Scheme Established Deficits

On 16 March 2016 we issued a second consultation paper on our proposals for changes to the way Pension Scheme Established Deficits (PSEDs) are funded and evaluated. Following consideration of responses to that consultation, the Authority[1] has decided to clarify the nature of our commitment to provide funding for PSEDs of network operators (NWOs) subject to price control under our RIIO regimes.

This decision confirms the proposals set out in our second consultation paper subject to some modifications. Although these modifications are important, we do not believe they alter the overall intent or effect of the proposed changes but incorporate further safeguards for the consumer.

Background

The defined benefit (DB) pension schemes sponsored by most NWOs have their roots in employee remuneration packages which existed before privatisation of the energy networks between 1986 and 1991. The present position reflects that legacy. All of these pension schemes are now closed to new members, but continue to accrue obligations in respect of pensionable service of remaining members. The obligations and the assets held by the schemes to fund those obligations remain substantial relative to the size of the businesses themselves[2]. In addition, the benefits available to employees of electricity networks at the time of privatisation are subject to protected persons legislation[3].

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

[1] The Gas and Electricity Markets Authority, or GEMA. In this letter, the terms 'Authority', 'we', 'us' and 'Ofgem' can be taken to mean GEMA.
[2] In broad terms, at the last actuarial valuations, liabilities average about 70% of the Regulatory Asset Values (RAV) of the NWOs, while their assets average about 60%.
[3] The Electricity (Protected Persons) (England and Wales) Pension Regulations 1990 (SI 1990/346).

contributions for accruing service (known as a pension contribution holiday) and the existence of a deficit would mean the employer should pay more money into the scheme.

Before we explicitly provided for funding of defined benefit pension scheme deficits, Ofgem's policy had been to provide funding for pensions as part of allowances for operating costs. We set those allowances at what we estimated to be efficient levels after carrying out benchmarking analysis of the companies' operating costs. At times, those costs incorporated the effects of pension contribution holidays.

We introduced price control pension principles in 2003 to guide our approach to dealing with pension costs and in particular the costs associated with deficit funding. We reviewed those principles in 2008[4] and committed to the funding of deficits arising from pensionable service accrued prior to the end of the price control periods in operation at that time.[5] We call these established deficits.

In our conclusion to that review, we envisaged that companies would be able to use this funding to reduce established deficits to zero within 15 years. To this end, we specified a mechanism to recalculate the annual level of funding required after each triennial actuarial valuation, so that established deficits could be reduced to zero by the end of the respective 15-year period.

A number of parties had told us that they were concerned about the operation of our commitment and this mechanism. The way we expressed our commitment meant it was not clear how we would treat any increase in valuations of established deficits after the end of these initial funding periods[6].

We identified that this uncertainty would create perverse incentives on NWOs, and trustees, to influence higher deficit valuations before the end of the initial funding periods to secure maximum funding and minimise the risk of unfunded deficits in due course. Trustees also told us that the resulting focus of our triennial reviews on valuation assumptions, with a view to penalising what we considered were 'inefficient' assumptions, caused some nervousness and inhibited new thinking in investment and other strategy.

We further identified that any uncertainty around our funding commitment would affect beta, or systematic, risks for NWO investors and thus our assessments of the cost of equity. This is because pension schemes hold a proportion of their assets in risky asset classes meaning that investors in an unprotected sponsoring employer would be exposed to the corresponding market risks.

Responses to our consultation

We received 15 responses to our 16 March 2016 consultation paper, which set out our detailed proposals at that time. We had nine responses from NWOs, four from pension scheme trustees, one from British Gas and one from actuarial advisers, Aon Hewitt. Three responses were confidential. All others have been published alongside this decision.

Companies and trustees generally welcomed the proposals. A number of these respondents emphasised particular aspects of the judgements that will be inherent in funding decisions but, in doing so, did not disagree with the underlying changes. Some responses included technical suggestions, particularly relating to the draft ED handbook chapter included as an appendix. We have made changes to the draft ED handbook chapter to reflect these and we will continue to work with NWOs to provide further clarity if required. The updated draft chapter is in Appendix 1 of this paper.

[4] https://www.ofgem.gov.uk/publications-and-updates/price-control-pension-principles
[5] These cut-off dates are 31 March 2010 for electricity distribution networks, 31 March 2012 for electricity and gas transmission networks and 31 March 2013 for gas distribution networks.
[6] We indicated we may provide for further consumer funding provided increases were outside the control of company managements.

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Two substantive concerns and a procedural concern were raised by British Gas.

- The first substantive concern related to the scope of the reasonableness review. British Gas considered our reviews should retain comparisons of approaches and assumptions. We proposed that "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". Our existing approach permits us to review further and potentially adjust the value of pension scheme deficits if we consider actuarial assumptions are outliers (compared with other schemes' assumptions). Our new approach permits us instead to adjust the profiles of Base Annual PSED Allowances and Payment History Allowances after consultation with the licensee and giving our reasons why the licensee's proposals do not appropriately protect the interests of consumers. We have decided to amend our draft financial handbook to make it clear that our reasons for doing so may include concerns surrounding actuarial assumptions.

- The second substantive concern related to how we proposed formulating the length of the 'indicative deficit repair period'. We proposed a period length that is the shorter of the period over which current levels of deficit payments would eliminate the deficit and 15 years. British Gas recommends it should be the higher of these values. This would mean, through our triennial review process, a potentially perpetual deferral of deficit payments as payments will always be deferred for a further 15 years. British Gas' recommendation would have a very significant greater effect on deferring payments compared with our current policy, which aims for elimination within the shortening periods ending at fixed dates in 2025 to 2028. We believe British Gas' recommendation would decrease trustees' confidence in our funding regime and inhibit the development of more consumer focused strategies.

- The procedural concern relates to the need for an impact assessment. Reflecting on this response, we have prepared an impact assessment, which is set out in Appendix 2.

Some respondents commented that they did not consider it appropriate to round the recovery of any deficit up to the nearest whole year as this would in some cases arbitrarily reduce the current funding levels. We agree with this and have made the appropriate changes to the draft financial handbook. This now states that the PSED repair period would not necessarily be a whole number of years.

<u>Engagement with the Pensions Regulator</u>

We have welcomed the positive engagement we have had with the Pensions Regulator (TPR) in reading across the revisions it made to its Code of Practice in 2014. TPR wrote to the Energy Networks Association (ENA) in August 2015 to say it believes its approach and ours are compatible, going on to say:

> *"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 to take consumer interests into account. And Ofgem's approach does not preclude trustees acting in members' best interests."*

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Details of our decision and next steps

Our decision will be reflected in revisions to three documents that are central to the way we treat pension 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 across successive price control periods, and
- consequential revisions to the Pension Deficit Allocation Methodology (PDAM).

We set out our revised guidance on our pensions principles in Appendix 3. We are not 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.

We will modify the financial handbook chapter for all sectors. As an example the draft chapter for RIIO-ED1 is set out in Appendix 1. In light of responses, we have made changes to the draft we included in our March 2016 consultation, marked-up in red.

Our intention is, as far as practicable to incorporate a uniform chapter to the financial handbook for all RIIO sectors. However, there will be some differences for the RIIO-GD1, ET1 and GT1 financial handbooks.

We will shortly be carrying out a consultation for all RIIO financial handbooks.

We consider that these revisions are sufficient to enable companies to encompass them as part of the next reasonableness review this year informed by actuarial valuations as at 31 March 2016.

Yours faithfully,

Ian Rowson
Associate Partner, RIIO Finance

This Appendix sets out a draft of the RIIO-ED1 version of Price Control Financial Handbook chapter on the revised financial adjustment methodology for Pension Scheme Established Deficit revenue allowances. The Price Control Financial Handbook is one of the Price Control Financial Instruments as set out in the Special Conditions. Our draft will involve similar modifications to chapter 3 in the Price Control Financial Handbooks for RIIO-ET1 (electricity transmission), RIIO-GT1 (gas transmission) and RIIO-GD1 (gas distribution).

Throughout Appendix 1, markup denotes changes to the draft version of the handbook circulated with the second pension consultation. Text in red represents additions, while ~~red text with strikethrough~~ represents deletions.

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.[7]

3.2 These allowances are represented by the opening EDE values[8] 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
- 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.

[7] 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.

[8] As at 1 April 2015.

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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[9] 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],~~
- the decision document on Ofgem's policy for funding Network Operators' Pension Scheme Established Deficits, dated 7 April 2017

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

Principle 6 - Severance - Early Retirement Deficiency Contributions
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.

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

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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[10], and

(c) the Reasonableness Review with respect to the price control pension principles which could, exceptionally, result in adjustments to the PSED figure on account of errors in methodology or data.

Asset-backed funding arrangements

3.11 The licensee may choose to enter into asset-backed funding arrangements with pension scheme trustees, either directly or indirectly through related parties. Such arrangements might include, 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.

[10]Energy Network Operators' Price Control Pension Costs - Regulatory Instructions and Guidance: Triennial Pension Reporting Pack supplement including pension deficit allocation methodology ("Pension RIGs")

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

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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.

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

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(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.

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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~~ 31 October 2017 (rr = 2017/18)	30 November 2017
31 March 2019	7 July 2020	31 August 2020	~~30 November~~ 31 October 2020 (rr = 2020/21)	30 November 2020
31 March 2022	7 July 2023	31 August 2023	~~30 November~~ 31 October 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.

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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 number of years (not necessarily a whole number) from the valuation date specified in Table 3.1 and is ascertained by taking the number of years that is the lower of:

(a) the value 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~~ 11.14 years, being the lower of:

(a) ~~12~~ 11.14, 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:

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

where:

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~~rpa~~ irp 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~~ 11.14 years, and the discount rate was 2%, the indicative Base Annual PSED Allowance would be ~~£93,626~~ £100k. IBAPA would equal EBAPA unless irp is limited to 15.

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.

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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.

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

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

$WACC_y$ 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, informed by practice in the regulated and broader private sectors, 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, reasons which may relate to levels of uncertainty in the assumptions adopted in the valuation of the PSED

(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.

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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~~ which would have the effect of 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.

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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 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

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Row	Due by	Event
		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~~ 31 October	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.~~
7	30 November	Ofgem will direct revised EDE values and will 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.

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Appendix 2 – Revision to the financial adjustment methodology for Pension Scheme Established Deficit revenue allowances – Impact Assessment

See attached

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Appendix 3 – Guidance note on price control pension principles under RIIO

This Appendix sets out our guidance on price control pension principles under RIIO. We are not making changes to the principles themselves. The guidance notes explain how we will 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 continued 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.

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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 **Error! Reference source not found.**.

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

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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. 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

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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.

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.

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