Pensions

Annex F

30 June 2017



About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs; Electricity; Gas; Retail and Social; and Water. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

Our Mission	Value and sustainability in energy and water.
Our Vision	We will make a difference for consumers by listening, innovating and leading.

Our Values

Be a best practice regulator: transparent, consistent, proportional, accountable, and targeted

Be a united team

Be collaborative and co-operative

Be professional

Listen and explain

Make a difference

Act with integrity

Contents

ACRONYMS AND GLOSSARY

Article 75 Payment	When an employer departs from a scheme they become liable to pay their share of the scheme's liabilities.
Augmentation of Benefit Cost	Cost associated with the provision of additional benefits offered to members of a DB scheme (other than enhanced pension benefits granted under severance arrangements), normally where the cost is borne by the scheme and/or the employer.
CC	Competition Commission- the predecessor of the CMA (below).
CMA	Competition and Markets Authority. The Competition and Markets Authority (CMA) is a non-ministerial government department in the United Kingdom, responsible for strengthening business competition and preventing and reducing anti-competitive activities. The CMA began operating fully on 1 April 2014, when it assumed many of the functions of the previously existing Competition Commission and Office of Fair Trading, which were abolished.
Cut–off Date	The 31 March 2012.
DD	Draft Determination.
Deficiency (or deficit) contributions –	Where an actuarial funding valuation shows that the scheme's assets are less than required to cover the expected cost of members' benefits which have accrued up to the valuation date (so the scheme is in 'deficit'), additional deficiency contributions will be required from the employer to make up the shortfall. Deficiency contributions are payable for a fixed term, known as the recovery period, after which the deficiency would be expected to have been eliminated.
Defined benefit pension scheme (DB scheme)	A pension scheme in which an employee's pension is determined under the scheme rules. In a final salary scheme, the pension is based on the number of years of service and on the employee's pensionable salary at, or shortly before, the employee leaves active service. In a career average scheme, the pension reflects the employee's average pensionable salary throughout his or her active service. The cost of providing the defined benefits will depend on the scheme's experience. In most schemes, the employer has to provide additional funds to the scheme to meet the cost of providing the defined benefits, if experience is worse than expected. In other words, the risk of adverse experience usually rests with the sponsoring employer. Conversely, the employer usually benefits from reduced contributions if experience is favourable.
Defined contribution pension scheme (DC scheme	A pension scheme in which the benefits paid to an employee depend on the level of contributions to the scheme, the investment return earned on the contributions, annuity rates at retirement and the provider's expense charges. There is no guaranteed level of benefits. In other words, the risk of adverse experience rests with

	the employee (who also benefits from any favourable experience).
Early retirement deficiency contributions (ERDCs)	The cost of providing enhanced pension benefits granted under severance arrangements prior to the cut-off date which were not fully matched by increased contributions.
Employer (sponsor) covenant	The degree to which the employer is willing and able to meet the funding requirements of the scheme.
Established Deficit	Difference between assets and liabilities, determined at any point in time, attributable to pensionable service up to the end of the cut-off date and relating to regulated business activities. The term applies equally if there is a subsequent surplus.
Funding Level	The ratio of the value of the pension scheme's assets to the value of its accrued liabilities. A funding level of 100% means that the pension scheme is deemed to be 'fully funded'; in other words, its assets are expected to be sufficient to meet the expected cost of the benefits accrued to the valuation date, on the basis of the assumptions adopted for the valuation. A 'fully-funded' scheme is not guaranteed to be able to meet its future liabilities; it is only an expectation based on the assumptions adopted.
FD	Final Determination.
Incremental deficit	The difference between the assets and liabilities, determined at any point in time, attributable to post cut-off date pensionable service and relating to regulated business activities. The term also applies equally where there is a surplus for the post cut-off date regulated Notional Sub-Fund.
Investment Management Fees	Any scheme investment management expenses which are charged separately or have not been implicitly allowed for under change in market value of investments or as a deduction from investment income.
Matching assets	Asset classes such as government and corporate bonds, whose cashflows can provide an approximate match to future pension payments, and whose market values may broadly reflect changes in the present value of the scheme's liabilities, depending on the method used to value the scheme's liabilities. Such assets are used to reduce a pension scheme's investment risk (in simplistic terms) but at the expense of lower expected long-term investment returns compared with return-seeking assets.
NIE Networks	Northern Ireland Electricity Networks (also referred to as NIE T&D and NIE).
Normal Pension Service Contributions	Contributions to a pension scheme to cover the normal pension service cost of that scheme.
Normal Pension	The actuarially-determined present value of retirement benefits

Service Cost	earned by plan participants in the current period, based on the company's existing pension benefit formula.
Pension Deficit Allocation Methodology (PDAM)	The Pension Deficit Allocation Method as described in Ofgem's 'Energy Network Operators' Price Control Pension Costs – Regulatory Instructions and Guidance: Triennial Pension Reporting pack supplement including pension deficit methodology' dated 12 April 2013 (v1.02 13 June 2013).
Pension Deficit Repair Payments	The cash cost paid, directly or indirectly, by the licensee to reduce a shortfall in a pension scheme's assets compared with its liabilities as set out in the deficit recovery plan agreed between the licensee and the pension scheme trustees, reported to the Pensions Regulator and certified by the pension scheme actuary, in accordance with the pension scheme rules.
Pension Hedging and Contingent Asset Cost	Costs of (a) hedging certain risk in a pension scheme (e.g. longevity, interest and RPI); and (b) a sponsoring employer funding a contingent asset provided to the pension scheme, incurred directly by the employer.
Pension Protection Fund (PPF) levy	- The cash costs paid, directly or indirectly, by the sponsoring employer(s) or pension scheme (in respect of the conveyance business) to the Pension Protection Fund.
Pension-related Severance Cost	The cost of providing enhanced pension benefits granted under severance arrangements.
Pension Scheme Administration Cost	The administrative cost for the operation of a pension scheme by the scheme trustees (excluding interest and taxation) including salaries and cost of pension scheme administrators and all other associated cost of administering the pension scheme, whether borne by the scheme directly or the employer(s) and not recovered from the scheme.
Protected persons	People covered by The Electricity (Protected Persons) (Northern Ireland) Pension Regulations 1992. The Protected Persons Regulations place obligations on successor employers to fund accrued pension rights. The Regulations also specify (broadly) that future pension rights cannot be reduced for Protected Persons unless a meeting of affected members votes in favour of the change by a two-thirds majority.
Regulatory fraction	Proportion of a company's pension scheme liabilities that relates to licensed regulated business activities before the relevant cut-off date. This fraction is after any adjustment that was made in price allowances for ERDCs.
RP5	This is the name given to the price control for NIE Networks, covering the period from 1 April 2012 to 30 September 2017.
RP6	This is the name given to the price control for NIE Networks, covering the period from 1 October 2017 to 31 March 2024.

1 Overview

Background

1.1 The NIEPS is a multi-employer scheme. This means that other companies (both regulated and non-regulated) are also members of the scheme. Current employers that participate in the NIEPS are: Northern Ireland Electricity Networks Ltd (referred to as NIE Networks throughout this paper) and Capital Pensions Management Ltd.

1.2 Before these companies were divested to the ESB Group in December 2010, the NIEPS was formerly known as the Viridian Group Pension Scheme (VGPS). In addition to the above companies, VGPS also included Viridian P&E, Viridian Group and others, NIE PPB and NIE Energy Supply (now Power NI). As part of the divestment to ESB, 91% of the VGPS deficit was transferred to NIEPS and 9% to the newly created Viridian Pension Scheme.

1.3 The pension scheme operates two sections as follows:

- Defined Benefit (DB) section, referred to as the 'Focus' plan; and
- Defined Contribution (DC) section, referred to as the 'Options' plan.

1.4 In March 1998, NIE (now NIE Networks) closed the DB section of the pension scheme to new entrants. Since then, new joiners are instead offered membership in the DC section of the scheme.[1] This is consistent with general trends in UK private sector pensions.

1.5 NIE Networks makes several types of payment to the scheme including:

- Ongoing pension payments to represent the cost of additional benefits being accrued by existing employees who are still members of the scheme (which are both DC and DB costs);
- Annual deficit repair payments which aim to bring the scheme into balance over a period of time (which are DB associated costs); and
- The Cost of insured risk benefits (which are DC related costs).

1.6 In the DB section of the scheme an employee's pension is based on the number of years of service and final salary with sponsoring employer(s). The level of future pension benefit and employee will receive is set; the investment risk lies with the employer(s).

[1] See Northern Ireland Electricity Limited: Transmission and Distribution RP5 Price Control, Statement of Case to the Competition Commission, 10 May 2013.

1.7 The Electricity (Protected Persons) Pensions Regulations (Northern Ireland) 1992 protect certain employees' pension benefits in respect of past and future service. This protection restricts the extent to which the NIEPS's benefits and member contribution rates can be changed.

1.8 In the DC section of the scheme an employee's benefits will be dependent on the contributions to, and growth of, the fund and the fund manager's investment and other attributable costs. There is no guarantee on the level of future pension benefit an employee will receive; the investment risk lies with the employee.

1.9 DC arrangements typically, but need not, involve lower employer pension contributions than a DB pension. Whether contributions are lower to a DC arrangement than to a DB scheme depends on the design of the two schemes.

1.10 The main difference between DB and DC provision relates to risk: in a DB scheme the employer bears the risk of adverse future experience through the possibility of deficiency contributions being required, whereas in a DC arrangement the risk of adverse future experience rests with the member through lower than expected benefits. Conversely, members benefit from favourable experience in a DC arrangement, whereas in a DB scheme the employer may benefit (depending on the scheme rules).

1.11 The NIEPS is governed by a trust deed and rules and is managed by trustees. Under the scheme rules, each participating employer is required to contribute to the scheme both by way of ongoing contributions and in terms of deficit repair. Trustees take into account the financial position of these companies and the strength of their covenants when forming a view of a deficit recovery plan for the scheme.

1.12 Participating employers make ongoing payments to the NIEPS associated with their current employees. With regard to the defined benefit plan, NIE Networks are also responsible for deficit repair payments associated with the cumulated member liabilities.

1.13 Employer contributions to the DB section were around £27 million in the year 2014-15 and £24 million in the year 2015-16 (contributions in respect of future benefit accrual represented around 30% of total contributions). Employer contributions to the DC section were around £2-3 million a year over the same period. As the DB section represents the greatest cost and risk to NIEPS, this annex mainly considers the DB section of the NIEPS.

1.14 For this FD we are mainly using pension scheme data from the triennial pension scheme valuation as at 31 Mar 2014 and also have considered other relevant material including funding updates. This triennial valuation provides a more detailed analysis of pension scheme aspects, assumptions and valuations than the annual or quarterly valuation updates. In addition, we also note that the company relies on the triennial valuations for setting the schedule of company contributions.

1.15 Pension scheme members include: current employees (active members), deferred pensioners and pensioners. Table 1 provides further details on membership numbers by scheme category as at 31 March 2014. As can be seen, only10.2% of the total

members of the DB section of the NIE Networks' pension scheme are active employees.

1.16 Table 1 illustrates the membership of NIE Networks' pension scheme as at 31 March 2014:

Scheme Section	Defined Benefit membership (Focus)	Defined Contribution membership (Options)
Actives	586	687
Deferred pensioners	752	752
Pensioners and dependents	4,391	56
Total	**5,729**	**1,495**

Table 1: NIE Networks' pension scheme membership breakdown as at 31 March 2014.

1.17 It should also be noted that the majority of active employees are 'Protected Persons' as outlined in the Electricity (Protected Persons) Pension Regulations (Northern Ireland) 1992. Protected persons are protected by status and their pension benefits cannot be reduced without their consent. This applies to both past and future service. As at 31 March 2016 there were only 34 active NIE Networks' employees who were not 'Protected Persons'.

1.18 Both the DC and DB sections of the pension scheme have:

- Normal ongoing pension service contributions
- Pension scheme administration cost[2] and investment management fees[3]

1.19 The DC section also has costs associated with risk benefits being insured.

1.20 In addition, there may be a range of other costs specific to the DB section of the scheme, which may include:

[2] The administrative cost for the operation of a pension scheme by the scheme trustees (excluding interest and taxation) including salaries and cost of pension scheme administrators and all other associated cost of administering the pension scheme, whether borne by the scheme directly or the employer(s) and not recovered from the scheme.

[3] Any scheme investment management expenses which are charged separately or have not been implicitly allowed for under a change in the market value of investments or as a deduction from investment income.

- Pension deficit repair payments[4]
- Pension Protection Fund (PPF)[5] Levies[6]
- Pension hedging and contingent asset cost[7]
- Augmentation of benefit cost[8]
- Pension-related severance cost[9]

1.21 NIE Networks proposed a net allowance of £84 million (in 2015-16 prices) for pension deficit recovery during the RP6 period. This proposal was to cover the costs of repairing the deficit in the defined benefit scheme to ensure that accumulated liabilities for both current and past employees are met.

1.22 In addition, NIE Networks proposed allowances for ongoing pension costs. These costs have been assessed and benchmarked in our Final Determination.

1.23 This Annex summarises our analysis of pension deficit elements of the NIE Networks' pension scheme for the RP6 price control. It furthermore provides a pension cost review for RP5 to determine whether any adjustment in respect of RP5 allowances may be required.

1.24 In conducting our analysis and review, we have considered the findings from the RP5 CC (Competition Commission) (now the CMA) determination[10] with respect to the treatment of pension costs, regulatory precedents and other relevant material.

Document Structure

1.25 This document is structured in a number of chapters as follows, each addressing different aspects of the price control:

[4] The cash cost paid, directly or indirectly, by the licensee to reduce a shortfall in a pension scheme's assets compared with its liabilities as set out in the deficit recovery plan agreed between the licensee and the pension scheme trustees, reported to the Pensions Regulator and certified by the pension scheme actuary, in accordance with the pension scheme rules

[5] Statutory fund created in the United Kingdom under the Pensions Act 2004 to pay compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation.

[6] The cash costs paid, directly or indirectly, by the sponsoring employer(s) or pension scheme (in respect of the transmission/distribution business) to the Pension Protection Fund.

[7] Costs of (a) hedging certain risk(s) in a pension scheme (e.g. longevity, interest and RPI); and (b) a sponsoring employer funding a contingent asset provided to the pension scheme, incurred directly by the employer.

[8] Cost associated with the provision of additional benefits offered to members of a DB scheme (other than enhanced pension benefits granted under severance arrangements), normally where the cost is borne by the scheme and/or the employer.

[9] The cost of providing enhanced pension benefits granted under severance arrangements.

[10] Competition Commission: Northern Ireland Electricity Limited price determination, Final determination, 26 March 2014.

- Section 2 - This section provides details on pension background, Business Plan submission and RP5 and RP6 pension aspects.
- Section 3 - This section discusses the Investment strategy.
- Section 4 - Defined Contribution Scheme details our analysis on costs relating to the DC section of the NIE Networks' pension scheme.
- Section 5 - Defined Benefit Scheme details our analysis on costs relating to the DB section of the NIE Networks' pension scheme.
- Section 6 - Pension Scheme Expenses- this section discusses pension scheme admin and expenses costs.
- Section 7 - Provides details of the UR FD allowances in relation to pensions.
- Section 8 - This deals with the monitoring of pension scheme funding.

1.26 We note that we also provide, in addition to the information contained in this document, a summary of the findings of our pension analysis in the RP6 Final Determination main document.

2 RP5 Pensions and NIE Networks' RP6 Business Plan

Pension Principles

2.1 In our RP5 draft determination, we proposed a number of principles in relation to pension aspects.[11] For the RP5 final determination, these principles were reviewed and set out as below.

'*The principles that we will adopt going forward are as follows:*

- *NIE T&D should be allowed to recover the efficient ongoing pension costs for employees who are members of either the defined benefit pension scheme or the defined contribution scheme.*
- *NIE T&D should be allowed to recover any deficit repair costs, associated with the defined benefit pension scheme for both NIE T&D and NIE Powerteam Ltd, which it cannot legally avoid.*
- *Customers will achieve the benefit of any surplus which may exist during future price controls.*
- *Pension scheme trustees have a legal obligation to manage the pension fund prudently and in accordance with good investment principles and actuarial practice. Assuming that these legal obligations are complied with, there is little opportunity for NIE T&D to achieve efficiencies in the way it manages the defined benefit scheme, other than by closing the scheme to new members.*
- *Pension deficits that occur in any price control period may have been influenced by avoidable or inefficient actions taken in previous price control periods. We will adjust for the impact of unfunded ERDCs.*
- *Pension deficits will be based on the most recent formal actuarial valuation.*'[12]

2.2 On 30 April 2013 the RP5 price control determination was referred to the CC (now the CMA). In its final determination, the CC ruled that the treatment of pension deficits as part of the RP5 price control should be consistent with Ofgem's treatment of pension deficits of distribution businesses in GB.[13]

2.3 Following-on from the CC determination, we published, in December 2014, a regulatory decision paper on pension deficit recovery. In this paper we stated the following: *'[...] the Competition Commission ruled that the treatment of the pension deficit of NIE should be consistent with Ofgem's treatment of pension deficits of distribution businesses in GB during the RP5 referral. The UR has decided that it is*

[11] See Utility Regulator: Northern Ireland Electricity Transmission and Distribution Price Controls 2012-2017, Draft Determination, 19 April 2012, paragraph 11.8.
[12] Utility Regulator: Northern Ireland Electricity Transmission and Distribution Price Controls 2012-2017, Final determination, 23 October 2012, paragraph 7.56.
[13] See Competition Commission: Northern Ireland Electricity Limited price determination, Final determination, 26 March 2014, paragraph 12.80.

appropriate to adopt these principles for the other NI regulated energy businesses that seek to pass through pension deficit costs through their regulated tariffs.'[14] We also stated: *'The UR position is that for consistency of treatment it is correct to ensure that each price control follows the same core principles.'*[15]

2.4 We stated in our final approach for the RP6 price control, published in December 2015, the following: '[... we] consider that the pension principles we apply in setting pension-related price control allowances should be consistent across all NI regulated energy businesses with defined benefit schemes as well as, in so far as reasonable and practical, also with the pension principles used by Ofgem. [...] For RP6, we therefore propose to build on the pension principles used as part of RP5. We may consider reviewing our pension principles in the future as part of a roll-out and alignment of pension principles across all NI regulated energy businesses with defined benefit schemes. '[16]

2.5 In setting allowances for RP6 we have considered UR precedents, CC determination for RP5, CMA relevant material and other regulatory precedents.

Consideration of Pension Cost Elements

2.6 As part of setting total revenues the Utility Regulator considers the treatment of pension costs.

2.7 In its pension submission for RP5, NIE T&D (now NIE Networks) requested £10.5 million of ongoing costs and £66.7 million of deficit repair costs to be allowed. In addition, the company expected that a £20.4 million underperformance in the pensions allowance for RP4 would also be recovered. These proposals rested on a total pension scheme deficit of £150 million (at September 2011), to be recovered over 11 years (from 31 March 2011).

2.8 The employer contributions for the Focus section of the NIEPS are higher than those for the Options Section. Total employer contributions to the DB section were around £27 million in 2014-15 and £24 million in 2015-16, compared to employer contributions to the DC section which were around £2.5 million and £3 million over the same periods. This equated to a higher percentage of *pensionable salary*, 28.6% of pay compared to the average of 9.5% of pay in the Options section. The employer contributions in the Focus section were in respect of normal ongoing contributions and also to recover the deficit in the funding of the pension scheme. Figure 1 shows the contributions paid in respect of each of the sections of the NIEPS and the breakdown of employer contributions in the Focus section.

[14] See Utility Regulator: Pension Deficit Recovery – A Utility Regulator Position Paper, December 2014, p. 2.
[15] See Utility Regulator: Pension Deficit Recovery – A Utility Regulator Position Paper, December 2014, p. 4.
[16] Utility Regulator: Northern Ireland Electricity Networks Ltd Transmission & Distribution 6th Price Control (RP6), Final Overall Approach, December 2015, paragraphs 128 and 129.

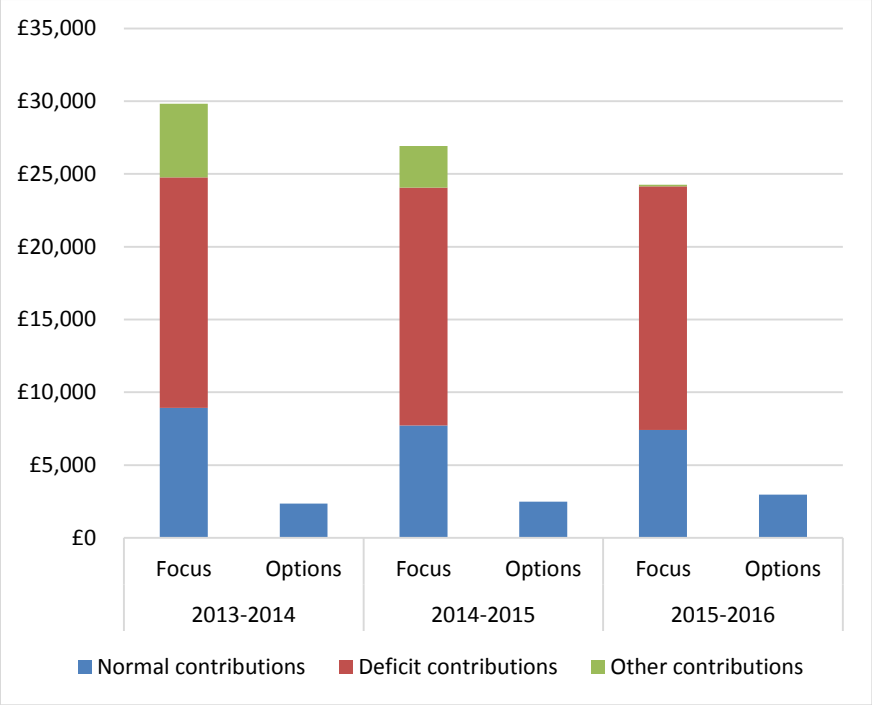

Figure 1: Employer contributions in the NIEPS

2.9 Ongoing pension costs are treated differently to the pension deficit recovery allowances. The former costs are subject to benchmarking in our Final Determination. Deficit recovery allowances and the UR's consideration thereof are dealt with in this Annex.

Pension Cost Review

2.10 The Utility Regulator recognises that the treatment of pension costs is an important area that has implications for energy consumers and a number of stakeholder groups.

2.11 RP6 takes place in the context of an existing pension scheme deficit in respect of the DB section. The Utility Regulator considers it of paramount importance to ensure that the reasons for the emergence and continuing existence of the deficit are analysed, and that in doing so, the Utility Regulator's primary objective of protecting the interests of consumers is met.

2.12 A funding deficit can arise in the defined benefit (DB) section of the pension scheme. A deficit is the amount by which the present value of the pension fund liabilities exceeds the value of the assets. The existence of a pension scheme deficit is not uncommon across the utilities industry in today's economic climate. Deficits have generally arisen from unfavourable changes in market conditions, where the increase in the value of the scheme's liabilities (which also reflect improvements in life expectancy) has not been matched by increases in the scheme's assets.

2.13 The Electricity (*Protected Persons*) Pensions Regulations (Northern Ireland) 1992 protect employees' pension benefits in respect of past and future service (the protection applies to those members who joined the NIEPS pre 1992). As benefit protections apply to over 95% of NIEPS members, the extent to which the NIEPS's benefits and member contribution rates can be varied is limited.

2.14 Deficit repair payments are cash amounts, agreed with the pension scheme trustees, which the company pays to reduce a pension scheme deficit.

2.15 In reviewing pensions, the Utility Regulator reviewed recent regulatory precedent, and also commissioned the Government Actuary's Department (GAD) to encompass pensions' expertise.

2.16 In determining price control allowances we consider the treatment of ongoing contributions in addition to the deficit including:

- the appropriate deficit amount to be considered,
- a deficit recovery period, and
- a regulatory fraction which can be applied to NIE Networks to ensure that consumers only fund the element of pension costs which apply to the regulated entity;
- any disallowance to be attributed to the employers' contribution in respect of the ERDC.

NIE Networks' Business Plan Submission for Deficit Recovery Payments

2.17 NIE Networks requested allowances for pension deficit recovery payments in its Business Plan. The amounts requested are shown in Table 2 below.

2.18 The pension deficit recovery allowance had a reduction applied in respect of the Employer Recovery Deficit Contribution. This is the amount of deficit recovery assumed to be attributed to the Employer – this approach is similar to the Competition Commission (now the CMA) allowance for RP5. The CC specified that 30% of the ERDC should be disallowed (based on a possible range of 23-45%).

2.19 In assessing RP6 allowances we have also considered whether this approach is still relevant and whether this assumption in relation to the ERDC disallowance should be retained.

2.20 In analysing requested amounts we have also determined the appropriate split of requested allowances between the transmission and distribution sections of the Business.

2.21 In its Business Plan NIE Networks requested amounts for the Transmission and Distribution sections of the business as shown in Tables 3 and 4 below. Due to the

fact that pension deficit funding costs relate to liabilities accrued over a number of years (including pre privatisation), NIE Networks considered the split of the closing RAB value to be a more reflective cost driver for allocation. The splits used by NIE Networks for allocating costs between the Transmission and Distribution businesses are shown in Table 2 below:

Split by business	10/2017-03/2018	04/2018-03/2019	04/2019-03/2020	04/2020-03/2021	04/2021-03/2022	04/2022-03/2023	04/2023-03/2024
Transmission	23.64%	23.52%	23.47%	23.54%	23.46%	23.35%	22.82%
Distribution	76.36%	76.48%	76.53%	76.46%	76.54%	76.65%	77.18%

Table 2: Transmission and Distribution business splits

2.22 The above splits result in the following BP request for the Distribution and Transmission businesses.

Distribution	Sept 17- Mar 18 £m	2018-2019 £m	2019-2020 £m	2020-2021 £m	2021-2022 £m	2022-2023 £m	2023-2024 £m	Total £m
Pension deficit contributions	6.7	13.5	13.5	13.5	13.5	13.5	13.6	**87.9**
Pension ERDC disallowance	-1.8	-3.6	-3.6	-3.6	-3.6	-3.6	-3.6	**-23.4**

Table 3: Distribution Business Plan requested amount

Transmission	Sept 17- Mar 18 £m	2018-2019 £m	2019-2020 £m	2020-2021 £m	2021-2022 £m	2022-2023 £m	2023-2024 £m	Total £m
Pension deficit contributions	2.1	4.1	4.1	4.1	4.1	4.1	4	**26.6**
Pension ERDC disallowance	-0.5	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	**-7.1**

Table 4: Transmission Business Plan requested amount

2.23 These requested amounts total to the amounts below in respect of the transmission and distribution sections of the business as a whole:

NIE Networks' Business Plan	Sept 17- Mar 18 £m	2018-2019 £m	2019-2020 £m	2020-2021 £m	2021-2022 £m	2022-2023 £m	2023-2024 £m	Total £m
Pension deficit contributions	8.8	17.6	17.6	17.6	17.6	17.6	17.6	114.5
Pension ERDC disallowance	-2.3	-4.7	-4.7	-4.7	-4.7	-4.7	-4.7	-30.5

Table 5: NIE Networks' Transmission and Distribution total

2.24 Over RP6 the total amount requested is as shown in Table 6 below:

	RP6 Request £m
Pension Deficit Contribution	114.5
Pension ERDC disallowance	(30.5)
Net Amount Requested	84

Table 6: Total RP6 requested pension allowance (2015-16 prices)

2.25 This compares to RP5 CC allowances as follows:

	RP6 Request (2015-16 prices) £m	RP5 FD (2009-10 prices) £m (Per CC)
Pension Deficit Contribution	114.5	75
Pension ERDC disallowance	(30.5)	(22)
Net Amount Requested	84	54

Table 7: CC Final Determination for RP5 compared to RP6 requested amounts

2.26 However, there are two important considerations when comparing the RP5 and RP6 amounts. The RP5 amounts are in 2009-10 prices as compared to the RP6 amounts which are in 2015-16 prices – inflation has increased by some 20% in this period. In addition RP5 is 5.5 years long as compared to RP6 which is 6.5 years long. When both sets of figures are stated in 09-10 prices and annualised, the amounts appear closer:

	RP6 Request £m (6.5 years) in 09-10 prices	RP5 FD (2009-10 prices) (5.5 years) £m (Per CC)
Pension Deficit Contribution	95.2	75
Pension ERDC disallowance	(25.4)	(22)
Net Amount Requested (£m)	69.8	54
Average annualised amount (£m)	10.7	9.8

Table 8: RP5 CC FD and RP6 Business Plan amounts compared

2.27 In determining pension costs we have analysed a range of related material including: Scheme Actuary actuarial valuation reports and funding updates, trustees' annual report and accounts, Focus and Options members' booklets, statement of investment principles, statement of funding principles, NIE Networks' business plan submissions, other publicly available pension information and approaches taken by other regulators including Ofgem.

2.28 It is a legal requirement that triennial actuarial valuations are carried out by occupational pension schemes. Since price controls last longer than three years, there is often an inevitable mis-match of implementing the price control using up-to-date actuarial results. During a price control period, a more up-to-date actuarial valuation will be completed which may report far-ranging results from the previous valuation.

2.29 Due to the fluctuations in pensions aspects, including deficits over time we will consider triennial valuation reports from 2009, 2011 and 2014 while also considering updated valuation reports. We will also consider the latest valuation reports available in considering our approach to pension costs.

2.30 Actuarial valuations represent a snapshot of the NIEPS's funding position at a point in time. Changes in market conditions, actuarial assumptions and other factors cause the funding position to change over time. In conducting our review we have considered the implications of events since March 2014 on NIE Networks' future pension contributions. The UR will monitor pension costs as part of the ongoing price control monitoring processes and we expect to receive triennial pension valuations from the company. In addition, the UR will be vigilant to other relevant factors in the pension environment (e.g. legislation changes or scheme specific changes) that may occur during a Price Control period.

RP5 Review

2.31 At RP5, one of the decisions involved basing price control allowances on a similar approach to that used by Ofgem, by adopting their Pension Deficit Allocation Methodology (PDAM) framework. We have maintained this approach for RP6 and NIE Networks completed the required PDAM information with their business plan submission. The PDAM approach involves the creation of two subfunds; one in respect of benefit accrual up to 31 March 2012 (the 'cut-off date') and one for benefit accrual after the cut-off date. Shareholders are fully responsible for any deficits emerging in the post cut-off date subfund (referred to as the 'incremental deficit'), whilst consumers effectively guarantee any deficits emerging in the pre cut-off date subfund (referred to as the 'established deficit').

2.32 Our review indicates that contributions during RP5 (and RP4) have been payable as expected, in line with the schedule of contributions and therefore we do not believe that any adjustments are required in respect of contributions for service accrual or deficit recovery, which account for the majority of NIE Networks' RP5 contributions. Therefore, we are not making any adjustment in respect of RP5 (or RP4).

3 Investment Strategy

NIEPS Current Investment Strategy

3.1 The October 2015 statement of Investment Principles states that the NIEPS's benchmark investment strategy is as follows:

- 20% invested in equities (classed as *return seeking* assets)
- 40% invested in absolute return funds (a mixture of return seeking assets, low risk assets and matching assets)
- 20% invested in multi-asset credit funds (classed as low risk assets)
- 20% in a LDI portfolio (classed as matching assets)

3.2 A key driver in the performance of scheme assets is the relative level of investment in return seeking assets. In March 2015, the NIEPS held around 46% of its assets (by market value) in 'return-seeking assets'.

3.3 Since the RP5 review, the NIEPS has changed its investment strategy. In common with many large schemes in the UK, the changes have led to more sophistication in the investment strategy (for example, through liability driven investments and investment in Diversified Growth Funds). The overall strategy risk is broadly similar, if not slightly higher, than in RP5 and the proportion of 'return-seeking assets' is towards the higher end of a typical range for a scheme of its maturity. We expect that having consulted NIE Networks, the Trustees have taken a reasonable approach in this area, recognising the strength of the employer covenant.

Figure 2 shows the NIEPS's investment allocation by market value at March 2009, March 2012, and March 2015, taken from the relevant actuarial valuation reports and funding updates. It also shows the average asset allocation for UK private sector defined benefit pension schemes in 2015 from PPF/tPR data[17].

[17] 'The Purple Book: 2015', PPF and tPR, Chapter 7.

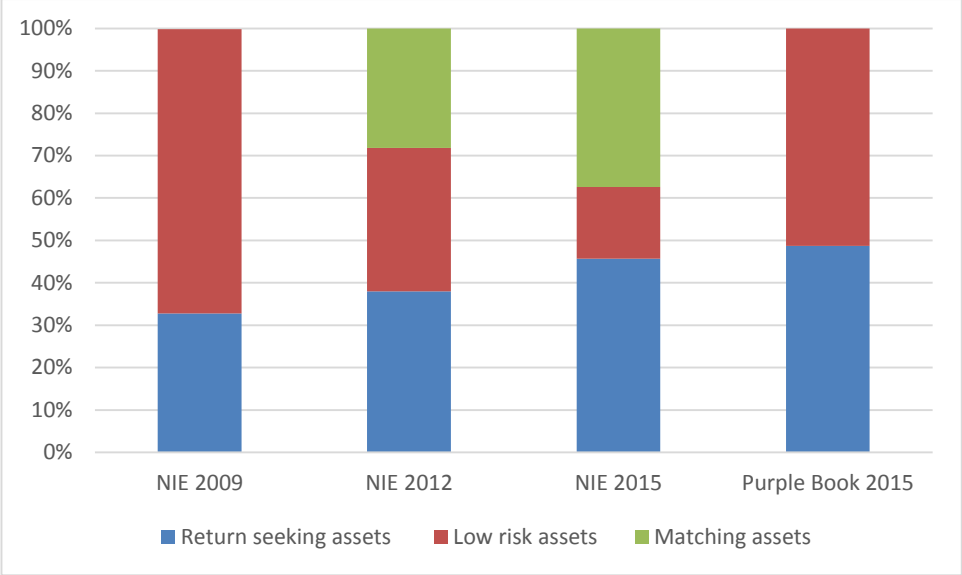

Figure 2: NIEPS' investments (from valuation reports and funding updates, at market value) and average allocation for UK private sector defined benefit schemes (from the Purple Book) – *percentage of assets*

3.4 Figure 2 shows investments in 'assets designed to match liabilities' for the NIEPS. The NIEPS' investment strategy now incorporates a de-risking objective with the aim of moving towards a broadly matched position over the long-term. The current approach incorporates a liability-driven investment (LDI) strategy. This type of approach is common among many UK private sector defined benefit pension schemes and such investments are included in the 'bonds' category in the Purple Book breakdown, due to its low risk, low return nature.

3.5 The Purple Book reports that just under 49% of UK private sector DB schemes' assets by market value was invested in return-seeking assets (including equities, property and hedge funds) on average in 2015. Therefore, this data suggests that a slightly lower percentage of the NIEPS's assets were invested in return-seeking assets than the average UK private sector pension scheme, but it is within a reasonable range. One of the main factors affecting investment strategy is the maturity of the scheme: other things being equal, a scheme with a more mature liability profile would be expected to invest a lower proportion of its assets in return-seeking assets. We expect that the Trustees, having consulted NIE Networks, would have considered this in formulating the investment strategy.

3.6 The 2015 Purple Book illustrates the relationship between investment strategy and scheme maturity, using the percentage of a scheme's liabilities attributable to current pensioners as a proxy for scheme maturity. Figure 3 shows approximate figures, based on Chart 7.9 in the 2015 Purple Book.

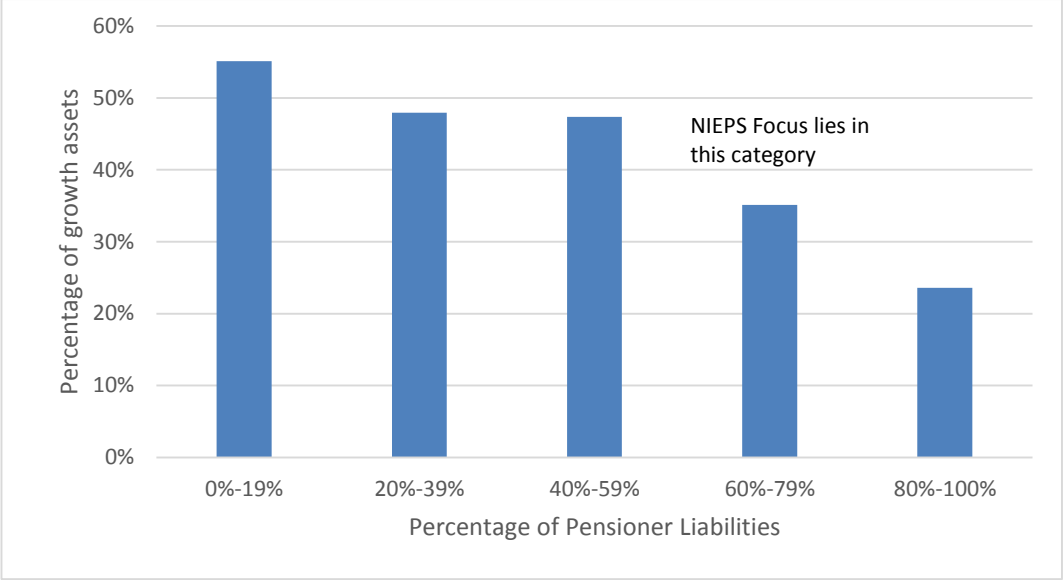

Figure 3: UK private sector defined benefit pension scheme average investment in return-seeking assets – by percentage of liabilities attributable to current pensioners – *percentage of assets*

***This increase is due to one large scheme which has shifted a lot of its assets into annuities.**

3.7 Approximately 74% of the NIEPS's liabilities at the 2014 funding valuation were attributable to current pensioner members. Figure 3 suggests that the average UK scheme with a sim*ilar membership profi*le would have about 39% of its assets invested in return-seeking assets. Therefore, the NIEPS's allocation of 46% to return-seeking assets is slightly higher than average after allowing for scheme maturity. However, we expect that the Trustees, having consulted NIE Networks, have considered the strength of its employer covenant in adopting such an investment strategy in anticipation of being able to generate higher investment returns over the long-term.

Pension Scheme Funding

3.8 In Table 9 we include an updated funding position for the 31 March 2015 and 2016 as a comparison, however these funding updates are not used to set contributory requirements and therefore do not fully reflect all the considerations of a formal actuarial valuation. The key advantage of using the latest full actuarial valuation i.e. the 2014 triennial valuation is that it represents the most robust assessment of the scheme.

	31 March 2012 £m	31 March 2014 £m	31 March 2015 £m	31 March 2016 £m
Funding:				
Assets	917	994	1,042	994
Liabilities	(1,073)	(1,104)	(1,223)	(1,201)
Surplus/(Deficit)	(156)	(111)***	(181)	(208)
Funding Ratio %	85%	90%	85%	83%
Typical GB Funding Ratio %	82.5%	89%	Unavailable	Unavailable
Typical GB recovery period	8.5 yrs	8.0 yrs	Unavailable	Unavailable

Table 9: NIE Networks' pension scheme data and comparison with GB pension schemes

*(***The RP5 CC decision specified established and incremental deficit elements. At 31 March 2012, the scheme had a deficit (i.e. the pre April 2012 fund- the established deficit). However, the post April 2012 fund (the incremental deficit fund) was created on that date so began in balance (zero assets and liabilities). Between 2012 and 2014, the funding position in both the pre/post April 2012 subfunds improved, resulting in a surplus in the post April 2012 subfund and a smaller deficit in the pre April 2012 subfund. The incremental deficit fund (Post April 2012) has a surplus of £2.4m included in the above figure due to favourable investment returns (which is 100% funded by shareholders).*

3.9 Data from the Pensions Regulator shows the spread of funding ratios for pension schemes. The upper quartile funding ratio was in the region of 98.4% and 'Lower quartile' ratio funding in the region of 79.9%, suggesting NIE Networks' funding is around the midpoint of scheme ranges in March 2014.

3.10 In summary:

- The NIEPS is a large scheme (liabilities exceeding £1billion), which is now relatively mature as the scheme was closed to new members in 1998. The scheme had approximately 77% pensioners compared with an average of 38% for similar sized schemes.
- The reported funding ratio is broadly similar to the GB scheme 'average';
- The agreed 8 year period over which the scheme will make deficit contributions (from the 2014 valuation) is within a 'typical' range;

Implications of the investment strategy

3.11 A key investment strategy decision is determining what proportion of the assets should be invested in return- seeking assets. The long term implications of different strategies are that other things being equal, less (more) investment in return-seeking assets implies:

- lower (higher) long-term expected investment returns; and therefore
- an expectation of higher (lower) long-term employer contributions (in order for

the scheme's assets to be able to meet future benefit payments); but with

- less (more) investment risk; so
- potentially less (more) volatile funding outcomes; and therefore
- potentially less (more) volatile overall employer contribution rates.

3.12 A possible implication of a relatively low (high) investment in return-seeking assets is a relatively high (low) employer contribution rate in the short term, due to actuarial valuation assumptions anticipating lower (higher) long-term investment returns.

De-risking strategies

3.13 We have observed that a key feature of the scheme's investment strategy is an objective to de-risk over the longer-term. In other words, the aim is to reduce the allocation to return-seeking assets and increase the level of matching assets. The advantage of matching assets is that they are expected to move broadly in line with changes (up or down) in the value of the liabilities. However, as these assets are considered to be lower risk, the expectation is that returns will be lower – over the long term – than returns earned on higher risk asset classes (for example, equities).

3.14 The approach and level of complexity involved in managing a transition to lower risk portfolios can vary considerably. Traditionally, schemes would look to move towards a de-risked position by increasing their allocations to gilts (using suitable proportions of index-linked and fixed interest gilts). In recent years, many private sector defined benefit schemes now follow more sophisticated approaches and this is the case for the NIEPS at this review.

3.15 All schemes have regard to the level of matching assets which their trustees believe is appropriate. The NIEPS make use of *liability-driven investment (LDI)* strategies to manage their exposure to risks such as interest rates and inflation. This is consistent with general market practice for larger-sized schemes[18]. We would expect that the Trustees, after appropriate consultation with NIE Networks, would have fully considered available strategies and options before formulating their investment strategy approach.

Other considerations

3.16 The percentage of the NIEPS's assets by market value invested in return-seeking assets reflects, in part, changes in market conditions over time. It is therefore not appropriate to place undue weight on the investment allocation at any particular date.

3.17 In their consideration of risk, one key factor for the trustees is the financial strength of the sponsoring employer (the employer's covenant). An *employer (or sponsor)*

[18] For example, Chart 31 in Aon Hewitt's Global Pension Risk Survey 2013 UK survey findings, shows that only 18% of large schemes (over £1bn of assets) do not have a policy for hedging interest rate and inflation risks.

covenant relates to the extent of the legal obligation and financial ability of the employer to support the funding requirements and investment risks associated with its pension scheme.

3.18 Other things being equal, a stronger employer covenant can support greater investment in return-seeking assets, due to the likelihood of the employer being able to meet any future deficits caused by investment losses. NIE Networks has stated that the NIEPS's trustees' view of its covenant is 'tending to strong'. The NIEPS's level of investment in return-seeking assets should be viewed in this context. All else being equal, schemes with a strong employer covenant are typically able to accept more risk in their investment strategies, which is ultimately expected to reduce the cost of providing benefits over the long-term. There is a trade-off in that higher anticipated returns are associated with increased volatility in asset values (and potentially funding outcomes).

4 Defined Contribution Scheme

Overview

4.1 The DB section (Focus) closed in 1998 and was replaced with a DC arrangement entitled Options for new entrants. This was consistent with pension progression trends at that time. The DC section of the NIEPS is fairly typical of a DC arrangement.

4.2 DC arrangements typically, but need not, involve lower employer pension contributions than a DB pension; although this is dependent on the design of the two schemes.

4.3 The main difference between DB and DC provision relates to risk: in a DB scheme the employer bears the risk of adverse future experience through the possibility of deficiency contributions being required, whereas in a DC arrangement the risk of adverse future experience rests with the member through lower than expected benefits. These effects will increase over time as more entrants join the DC section rather than the DB section. Conversely, members benefit from favourable experience in a DC arrangement, whereas in a DB scheme the employer may benefit (depending on the scheme rules). Overall, pension costs are expected to reduce over time as more entrants join the DC arrangement.

4.4 The employer contribution rates payable to Options are slightly higher than average, although still broadly in line with rates typically paid into DC schemes of other UK private sector employers. Contributions to the Options section typically range from £2-3m per annum.

Normal Ongoing Pension Contributions

4.5 Following the most recent formal actuarial valuation in 2014, NIE Networks' 'average' contribution rate to the DC section (9.5% of pay) of the NIEPS was significantly lower than its contribution rate to the DB section (28.3% of pay in respect of benefit accrual, plus additional contributions to address the scheme's assessed deficit and ongoing administration costs).

4.6 Employer contributions to the Options section are typically in the region of £2-3 million a year. This is significantly lower than contributions to the Focus Scheme (see section 2 for additional detail).

4.7 NIE Networks' future contributions to the DC section are expected to be more certain than those to the DB section. This is because, in the DC section, the contribution rates (not the level of benefits) are specified in the scheme rules (other than for some death and ill-health benefits). The employer risk of future funding shortfalls applies only to the DB section, not the DC section.

4.8 NIE Networks' contributions to the DC section, Options, depend on the following factors:

- The contribution rates specified in the scheme rules;
- The rates at which scheme members elect to contribute (because NIE Networks matches member contributions up to 7% of pay);
- The payroll of scheme members; and
- NIE Networks' contributions for death and ill-health benefits (which are not met entirely by members' pension accounts), and to meet administration expenses.

4.9 Employees in the DC section of the NIEPS can choose how much to contribute, subject to a minimum contribution of 2% of pay. NIE Networks matches the employee's contributions up to 7% of pay (an increase from 6% of pay before 1 January 2015) and contributes an additional 1% of pay for employees with over ten years' service, with an extra 1% of pay for employees with over 15 years' service, introduced from 1 January 2015. NIE Networks pays further contributions in respect of death and ill-health benefits (estimated as 3.7% of pay from 1 April 2012, increasing at 1 April 2015 to 4.3%) and to meet administration expenses (0.4% of pay from the 2014 actuarial valuation).

4.10 The structure of contributions to the DC section, whereby NIE Networks matches employee contributions on a 1:1 basis up to a limit (7% of pay here), is fairly typical.

4.11 NIE Networks' average contribution rate to the DC section at the time of the 2014 actuarial valuation was 5.2% of pay in respect of retirement benefits. The valuation report showed further contributions at an average of 3.9% of pay in respect of death and ill health benefits (consistent with the estimates of 3.7% of pay from 1 April 2012, increasing to 4.3% of pay at 1 April 2015). Contributions were also paid to meet administration expenses (0.4% of pay) giving a total of 9.5% of pay as an average at the 2014 valuation. This is an increase from 7.7% at the 2009 valuation.

4.12 Figure 4 shows the range of member contribution rates payable by NIE Networks into the DC section, including the minimum rate, the average rate at the time of the 2014 valuation and the maximum rate (for a member who personally contributes at least 7% of pay and is eligible for the extra contributions due to long service).

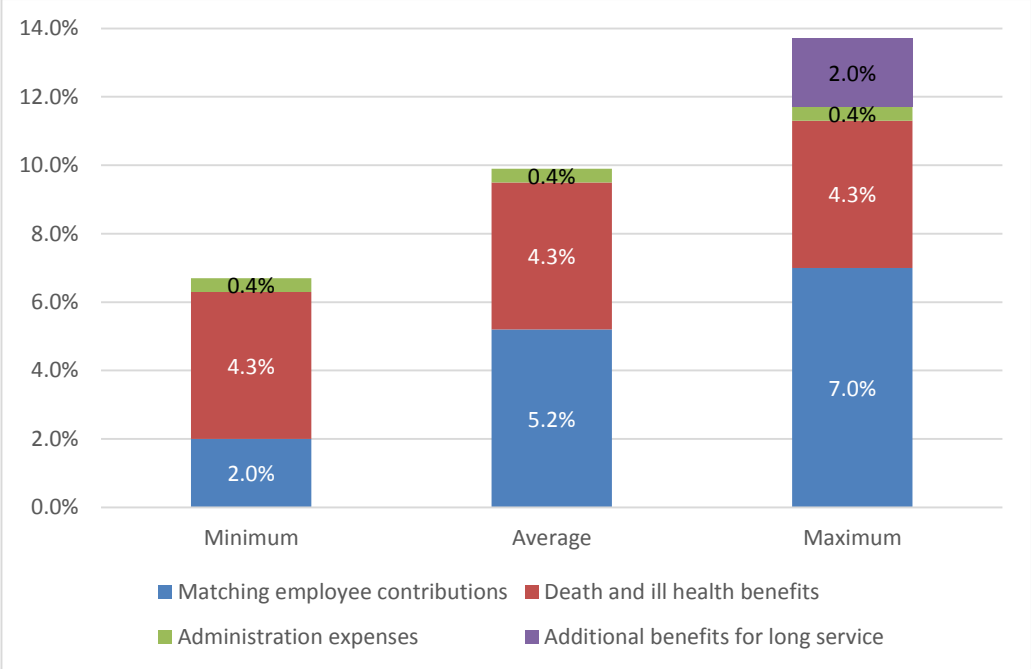

Figure 4: Contribution rates payable by NIE Networks in respect of the Options section on the NIEPS.

Comparing DC contribution rates

4.13 ONS survey data[19], suggests that the average employer contribution rate to private sector DC occupational pension schemes was around 2.9% of pay in 2014. This is a significant decrease from 6.1% in 2013. However, this decrease is largely due to the recent workplace pension reforms and introduction of auto enrolment.

4.14 A 2016 Aon Hewitt[20] survey reported an average DC employer contribution rate of 7.5% in 2014 and noted the impact of auto enrolment pulling average rates down. Similarly, the Association of Consulting Actuaries pension trend survey showed the average employer contribution rate for Trust based DC schemes falling from 6.9% in 2013 to 5% in 2015.

4.15 Overall, the average employer contribution of 9.5% (with 5.2% for retirement benefits) paid by NIE Networks appears to be slightly higher, but not significantly out of line with the contributions paid to other private sector DC occupational pension schemes, recognising that a comparison of schemes established prior to the introduction of auto-enrolment would be more appropriate.

4.16 Ongoing DC contributions are included in our benchmarking exercise within the FD.

[19] https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/pensionssavingsandinvestments/bulletins/occupationalpensionschemessurvey/2015-09-24#contribution-rates-in-private-sector-occupational-pension-schemes

[20] Aon Hewitt DC Member Survey 2016 – page 8

Options section - member choices

4.17 In the year ending 31 March 2016 there were ten investment funds available to members of the Options section. Following changes in Government legislation, which provide more flexibility for Options members when drawing their retirement savings, the Trustees have changed the Options Lifestyle strategy options with effect from 1 April 2015. From 1 April 2015, there were three lifestyle strategies available:

- The Drawdown Lifestyle strategy which will use a mix of investments designed for members who want retirement flexibility;
- The Cash Lifestyle strategy, for members who plan to take all of their retirement savings as cash at, or soon after their selected retirement age; and
- The Annuity Lifestyle strategy, for members who want to buy an annuity

4.18 The design of the Options section, as described in the preceding paragraph, is typical of that which might be expected for a DC scheme of its size, and the lifestyle strategies available are reflective of recent changes in legislation.

5 Defined Benefit Scheme

Overview

5.1 The principal benefits provided by the Focus section of the NIEPS are summarised in Table 10. The NIEPS benefits are unchanged since the last review in 2011. This table also shows the benefits offered by 'typical' UK private sector DB schemes from ONS survey data.[21]

	NIEPS Focus section 2014	'Typical' UK scheme 2014
Age at which unreduced benefits are paid (NRA)	60 or 63[1]	65
Accrual rate	60ths	60ths
Dependants' pension after death of member	50%	50%
Benefits on ill-health	Enhanced pension	Enhanced pension
Lump sum on retirement	By commutation	By commutation
Member contributions (% of pay)	6%	5.2%
Pension increases (in payment)	CPI[2]	RPI/CPI with cap[3]

Table 10: NIE Networks' pension scheme benefits (Focus section)

Source: 'Typical' UK scheme: Occupational Pension Schemes Annual Report 2014 (ONS)

[1] 63 years for post-April 1988 entrants. The cost of unreduced employer-approved early retirement benefits is met by NIE Networks.

[2] Future NIEPS pension increases reflect Consumer Prices Index (CPI) increases. Increases above 10% are at NIE Networks' discretion.

[3] UK private sector DB pension schemes' pension increases typically reflect increases in either the Retail Prices Index (RPI) or CPI, depending on the scheme rules. Increases are often capped at 2½% or 5% pa.

Pension contributions and ongoing pension costs

5.2 Table 10 shows that the NIEPS's DB section's benefits are slightly more generous than those provided by typical UK private sector DB schemes. The lower age at which unreduced benefits may be paid (63 or lower, rather than 65) and the higher annual cap on pension increases (10% with discretionary increases above this level, rather than a 2½% or 5% cap) provide more generous benefits. Conversely, the slightly higher rate of member contributions (6%, rather than 5.2%, of pay) and CPI-linked pension increases are less generous than some other schemes.

5.3 This comparison with a 'typical' UK private sector DB scheme is approximate only. It considers pension benefits in isolation, ignoring industry- or company-specific factors and other elements of the remuneration package.

[21] 'Occupational Pension Schemes Survey 2014', Office for National Statistics (ONS), Section 10.

5.4 The NIEPS's benefits reflect, in part, its public sector origins and protections put in place at privatisation. They also reflect, in part, past benefit improvements to utilise valuation surpluses. For example, the scheme's *accrual rate* was increased from 62nds to 60ths following the 2000 actuarial valuation. We note that if this change had not been made, NIE Networks' future pension contributions would be lower.

Pension Deficit

Deficit recovery and RP6 Business Plan submission

5.5 Pension schemes can be in surplus or deficit – this is measured by reference to the value of pension assets against the respective pension liabilities to produce an overall deficit or surplus.

5.6 A key feature of the Defined Benefit scheme is the current deficit- the most recent triennial actuarial valuation as at 31 March 2014 showed a deficit of £110.7m. The deficit changes with movements in financial markets, level of contributions, membership changes and other assumptions.

5.7 The employer will be required to address the deficit via additional contributions. By the same merit, when a fund is in surplus, an employer may take contribution holidays. The deficit repair contributions payable by NIE Networks amounted to £16.5m for the year ended 31 March 2016. In its Business Plan submission, NIE Networks have assumed that deficit recovery payments will be continued to 2024 (and beyond).

5.8 NIE Networks have calculated that the total pension deficit contributions expected to be payable during RP6 as £114.5million, ignoring the early retirement deficit contribution adjustment of £30.5m. NIE Networks are requesting a net allowance for pensions of £84million for RP6.

5.9 The amount requested by NIE Networks includes deficit contribution payments which extend for two years beyond the existing deficit recovery period. The extra two years' contributions are being requested by merit of the value of the deficit currently anticipated at the 2017 valuation exceeding that previously expected at the time of the 2014 valuation.

5.10 The CC set a deficit repair allowance to remove the deficit over 10 years from the commencement of RP5, which also matched the existing payment profile between the company and Trustees. NIE Networks indicated in its comments to the CC that having a notional 'stop dead date' was not appropriate as circumstances outside their control may increase the deficit.

5.11 The CC said (in paragraph 12.36 of the FD) 'In our view, this would be a matter for UR to decide at subsequent regulatory determinations'. The CC in a footnote indicated the following: 'the deficit repair period might be extended by the UR in order to protect different generations of consumers.'

5.12 In NIE Networks' Business Plan submission the company has continued to profile deficit recovery contributions for the two final years of RP6 to 2024, beyond the RP5 CC recommendation of ending by 2022. In its response to a UR query NIE Networks stated that it considered that current contributions would be insufficient to reduce the deficit at September 2016 of £262.8m by 2022 and that it considered that the recovery plan would continue beyond 2022, but at higher levels.

Early Retirement Deficit Contributions (ERDC)

5.13 Between 1997 and 2003, when the NIEPS was in surplus, early retirement benefit enhancements were granted, increasing the scheme's liabilities, but no additional contributions were paid into the scheme at the time. At RP5, following extensive consideration, it was decided that shareholders should fund part of these unfunded liabilities by disallowing 30% of deficit repair contributions. It was noted that a case could be made for an allocation of between 23% and 45%, however a 30% allocation was adopted on the basis that no compelling evidence was presented that the overall effect of this was either too harsh or too generous.

5.14 NIE Networks allowances requested for RP6 have been derived consistently with the RP5 decision that 30% of the historic unfunded *ERDC* liabilities should be funded by shareholders. NIE Networks explained the rationale for this in its Business Plan:

'We have also included a disallowance in respect of the RP5 determination that NIE Networks' shareholders should be responsible for funding 30% of the cost of granting enhanced early retirements in the late 1990s and early 2000s which were not funded by NIE Networks at the time'

5.15 We see no reason for altering the approach adopted by the CC and are retaining the percentage disallowance of 30%.

Deficit Considerations

5.16 It is recognised that there is currently a deficit in the NIEPS. There was a deficit balance at RP5 and the scheme is still in deficit. However, an important consideration is the deficit recovery payment profile.

5.17 The CC in its determination ruled that the historic deficit repair allowance for RP5 should match the deficit repayment profile that NIE Networks have agreed with the trustees of the pension scheme (that is £13.7m per annum during RP5 in 09-10 prices).

5.18 In addition, the CC considered there was merit in adopting differing approaches to the historic (or established) deficit and those relating to any new incremental deficit costs which may arise from additional pensionable benefits awarded to employees in the period. This is the approach also adopted by Ofgem.

5.19 The established deficit represents the difference between assets and liabilities attributable to pensionable service up to a defined cut-off date. The incremental deficit represents the difference between assets and liabilities for any pensionable service after this date.

5.20 The CC determined that the cut-off date for the established deficit should be the 31 March 2012. The CC further stated that in their view NIE Networks would have only limited ability to mitigate the established scheme deficit. They decided that costs relating to any incremental deficit should be funded by shareholders as it would have a much greater ability to influence its forward looking pension costs.

5.21 The CC suggested a ten year deficit recovery period (from the start of RP5) of £13.8m adjusted to £13.7m to allow for regulatory fraction of 99.26% (discussed below).

5.22 The CC also stated that there should be an adjustment at the end of RP5 for any financing costs (using NIE Networks' WACC for RP5) resulting from changes in the repayment profile during RP5, neither NIE Networks (or consumers) should be worse off in NPV terms than if there were recalculations during RP5.

5.23 The results of the 2011 funding valuation determined the contributions payable for the majority of the RP5 price control period. The results of the 2014 funding valuation determine NIE Networks' pension contributions going forward.

Figure 5 shows the principal reasons for the increase in the NIEPS's deficit from £87.6 million at 31 March 2011 to £110.7 million at 31 March 2014, as shown in the report on the 2014 funding valuation:

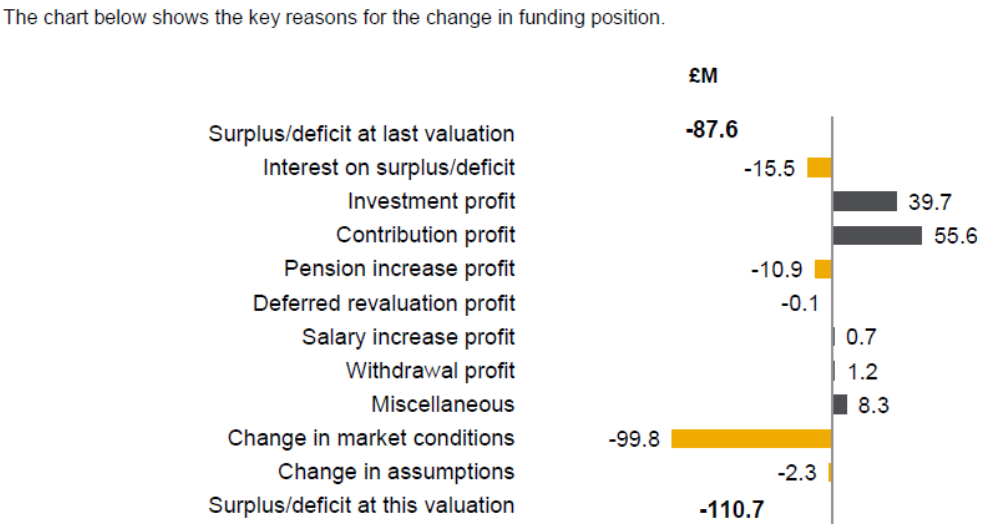

Figure 5: NIEPS funding valuations – change in valuation surplus (deficit) between the 2011 and 2014 valuations

5.24 Figure 5 shows that the principal reason for the increase in the deficit between the 2011 and 2014 valuations was the change in market conditions, in particular the fall in gilt yields relative to inflation which has caused the value of liabilities to increase significantly and therefore increase the deficit value.

5.25 The 20 year UK gilt yield fell from 4.31% at the 31 March 2011 to 3.35% as at 31 March 2014. This affects the assumed pre-retirement and post-retirement discount rate. A lower discount rate (or assumed rate of return) means that the scheme's assets are expected to generate lower investment returns, and therefore the scheme needs to hold more money now in order to meet future benefit payments. Therefore, the value placed on its liabilities is higher, which increases the deficit, so its funding level is lower, and its standard contribution rate (SCR) is higher.

5.26 These effects were partially offset by a gain of £95.3 million due to additional deficit recovery contributions paid by NIE Networks and investment profit.

5.27 The valuation deficit of £87.6million as at 31 March 2011 was met by additional employer contributions of:

- £12.74m in equal monthly installments from 1 April 2011 to 31 March 2012; and
- Contributions of £15.38 million a year payable monthly from 1 April 2012, increasing each subsequent 1 April by the increase in the Retail Price Index between the previous 1 September to 31 August period, until 31 March 2022.

5.28 The valuation deficit of £110.7 million as at 31 March 2014 will be met with an unchanged schedule of contributions of:

- £16.348m in equal monthly installments from 1 April 2014 to 31 March 2015; and
- Contributions of £16.74 million a year payable monthly from 1 April 2015, increasing each subsequent 1 April by the increase in the Retail Price Index between the previous 1 September to 31 August period, until 31 March 2022.

5.29 These contributions should be more than sufficient to meet the valuation deficit of £110.7 million. The report on the 2014 funding valuation notes that this was to take into account the further fall in government yields after 31 March 2014.

5.30 However, in its RP6 Business plan, NIE Networks have proposed contributions beyond the 2022 proposed by the CC. This results in additional deficit funding in the range of £25m for the 2022-2024 period; which is beyond the period included in its current schedule of contributions. NIE Networks have proposed additional contributions to the 2022 targeted deficit recovery end date proposed by the CC following the deficit increasing in recent pension valuations (annual and quarterly funding updates). The deficit balance has increased – largely due to gilt rates and NIE Networks consider it will be necessary to continue to make deficit recovery payments.

5.31 We have considered the request made by NIE Networks and recognise that the deficit balance may well have increased. However, these balances are derived from

annual and quarterly valuations which are not as comprehensive and detailed as the triennial valuations. The latest valuation was in 2014 and the next is not until 31 March 2017 which will not be available until actuarial reviews have been undertaken. We also appreciate that pension scheme valuations may fluctuate dependent on market conditions and valuations may vary markedly from valuation to valuation and there is currently no requirement for kneejerk reactions to valuations.

Approach taken by other regulators

5.32 We have been vigilant to the practices adopted by other Regulators in recent years and outline some of our observations below.

5.33 Ofgem has consulted on its approach to pensions in recent years (May 2015 and March 2016). It has published its decision on 7 April 2017 and this may be accessed at: https://www.ofgem.gov.uk/publications-and-updates/decision-ofgems-policy-funding-pension-scheme-established-deficits

5.34 Ofgem has been focusing on pension deficit recovery periods and had initially been prescribing appropriate deficit recovery periods. Ofgem had previously envisaged pension scheme deficits being repaid over a fixed 15-year period. However, having identified some potential issues with the use of a fixed 15-year period and a 'stop dead' date (for example, use of excessive margins for *prudence* in actuarial valuations carried out in the run up to the 'stop dead' date), Ofgem's expected future direction will include more flexibility by not specifying what the *recovery period* should be, provided it is funded over a reasonable period.

5.35 Ofgem has been exploring various options including not prescribing deficit recovery periods – but rather encouraging trustees to run pension schemes in an efficient manner. Ofgem has challenged their regulated companies to demonstrate that they have taken consumer interests into account in setting strategies. Further, it has challenged companies to demonstrate that good governance procedures are in place and that schemes' running expenses are demonstrably value for money.

5.36 We note that Ofgem may modify the level of pension scheme schedule of contributions payments following analysis of pension scheme triennial reviews.

5.37 In contrast to the Ofgem approach, Ofwat disallowed 50% of deficit contributions as it believed this would create a stronger alignment between the shareholders and consumer interests. Ofwat has also stated that it will allow no more deficit contribution payments beyond the end of the recovery plans agreed in 2009 (effectively introducing a fixed end point for consumer support of pension scheme deficits). The end dates for these recovery plans typically range from 2019 to 2025.

5.38 We also note the recent approach adopted by Ofcom. Ofcom disallowed all deficit contributions in determining pension cost allowances for BT. The regulatory approach on this point appears quite wide.

5.39 We will continue to be vigilant to regulatory practices in this area and the steps taken by other Regulators in this remit. In addition, we may consider reviewing the treatment of pension deficits across utilities and price controls in the future.

NIE Networks' business plan submission – deficit recovery

5.40 NIE Networks submitted the following requirements in relation to the pension deficit recovery over RP6:

	6 mths to 31/03/18 £m	18/19 £m	19/20 £m	20/21 £m	21/22 £m	22/23 £m	23/24 £m	Total £m
Distribution Costs - Pension deficit contributions	6.7	13.5	13.5	13.5	13.5	13.5	13.6	87.9
Distribution Costs - Pension ERDC disallowance	-1.8	-3.6	-3.6	-3.6	-3.6	-3.6	-3.6	-23.4
Total Distribution pension costs	**4.9**	**9.9**	**9.9**	**9.9**	**9.9**	**9.9**	**10**	**64.4**
Transmission Costs - Pension deficit contributions	2.1	4.1	4.1	4.1	4.1	4.1	4	26.6
Transmission Costs - Pension ERDC disallowance	-0.5	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-7.1
Total Transmission pension costs	**1.6**	**3**	**3**	**3**	**3**	**3**	**2.9**	**19.5**
Total T& D pension costs	**6.5**	**12.9**	**12.9**	**12.9**	**12.9**	**12.9**	**12.9**	**83.9**

Table 11: NIE Networks' RP6 Business Plan submission for deficit recovery

Pre and Post Cut-off Date Assets and Liabilities

5.41 In the RP5 CC FD, the CC decided that with regard to the **scheme deficit**, in which the current scheme has insufficient assets to cover its liabilities it was split into 2 areas:

- *an **established deficit** (represents the difference between assets and liabilities attributable to pensionable service up to 31 March 2012 and 100% funded by consumers) and;*
- *an **incremental deficit** (represents the difference between assets and liabilities for pensionable service from the 1 April 2012 and 100% funded by shareholders;).*

5.42 Below is the extract that the CC used to deal with this issue in the RP5 FD (12.27):

> Based on our view that NIE is likely to have a limited ability to mitigate the historic scheme deficit, we decided that in principle (and before considering any special items) 100 per cent of historic deficit repair costs should be passed through to consumers during RP5.

5.43 The deficit repair allowances to recover the costs in relation to the established deficit were set to the 31 March 2022. This related to a 10 year period from the commencement of RP5 and is similar to the approach used by Ofgem. This also matched the payment profile between the company and the trustees.

5.44 This principle is similar to the one Ofgem has in place for GB DNOs. We note that the reasons the CC gave for this decision have not changed and are not changing this principle in RP6.

5.45 The CC also suggested an in period adjustment Mechanism which makes changes to the payment schedules, normally after an actuarial valuation, to reflect the scheme needs, is deferred to the start of the next price control on the basis that NIE and consumers are kept NPV neutral due to timing.

5.46 Furthermore, with regard to the Deficit repair payment from RP4 in excess of RP4 allowance- the CC decided not to provide any allowance for costs incurred in RP4 in excess of those allowances provided in RP4.

5.47 We have followed the CC recommendations and as part of its Business Plan submission for RP6, NIE Networks were required to complete a Pension Deficit Allocation Methodology spreadsheet (PDAM). The PDAM is based on the Ofgem methodology and shows the methods used by the company to allocate the pre and post cut-off assets and liabilities.

5.48 We will retain the CC's approach to allocating pre and post cut-off assets and liabilities and funding principles, whereby consumers are responsible for the pre fund and shareholders for the post fund. We have considered the allocations and assumptions used by NIE Networks in determining pre and post cut-off assets and liabilities in making our proposals.

Update of Regulatory Fraction

5.49 The Regulatory Fraction is used to allocate pension costs which are deemed to be associated with regulated activities.

5.50 The CC Final determination for RP5 reflected a Regulatory Fraction of 99.26% and this fraction is relevant for the established deficit (which covers accrued benefits up to 31 March 2012). At RP5, following extensive consideration the CC decided 99.26% to be the most appropriate of the options evaluated.

5.51 NIE Networks' RP6 submission reflects an allowance for a pre-adjusted *Regulatory Fraction* of 99.26% (in line with the final RP5 determination) which is used to calculate the position in the pre *cut-off date* subfund, and identify the *established deficit*.

5.52 We note that a 3.7% adjustment has been applied in respect of an *article 75 payment* (as Powerteam Electrical Services (UK) Ltd ceased to participate in the scheme on 24 December 2013) which will increase the proposed RP6 allowances. The total scheme deficit has been split according to regulated or non-regulated status. NIE Networks have adjusted the *Regulatory Fraction* so that the surplus emerging in respect of the PES *article 75 payment* is treated as non-regulated surplus (and so increases RP6 allowances).

5.53 At the DD we proposed setting this regulatory fraction as 100% for RP6 and going forward (for the avoidance of doubt this is the pre-adjusted regulatory fraction). This would have resulted in an increased allowance in the range of £0.8m for removal of the regulatory fraction and the setting of this value to 100%. We proposed this adjustment to result in notable admin, resource and actuarial cost savings in RP6 and beyond for the company and Regulator in reporting, separating and auditing this element. However, following consideration of consultation responses and further analysis in this area we are not setting the Regulatory Fraction to 100% at this time. However, we will continue to monitor the level of Regulatory Fraction, its calculation and assumptions and may modify this going forward – should we consider it to be in consumers' interests.

Funding methodology and assumptions

5.54 The results of a pension scheme's funding valuation and therefore the sponsor's cash contributions depend significantly on the assumptions made for future experience. It should be noted that assumptions affect the timing of when contributions are payable, rather than the actual long term cost which will depend on experience.

Assumed rates of pay increases and salary strain mechanism

5.55 The allowance for future pay increases are comprised of two elements:

- Assumed future general (inflationary) pay increases; and
- Assumed future pay increases due to promotion and progression.

5.56 Higher pay increases would result in higher pension benefits and increased costs. The assumed rate of future general (inflationary) pay increases is equal to the assumed rate of RPI at the 2014 valuation. This is a decrease from the 2011 valuation assumption of RPI + ½%. In addition, we note that the 2014 valuation does not allow for any promotional increases in salary, which reflects a change from the 2011 valuation. The report on the 2014 valuation states that the reduction in the assumed rate of pay increases relative to price inflation reflects the Company's latest views on future salary growth.

5.57 A Salary Strain Mechanism has been agreed such that the Company will pay additional contributions to the Scheme if salary increases exceed the assumption. The mechanism is described in detail in the Statement of Funding Principles dated 27 May 2015.

5.58 We expect that the assumed rates of pay increases should reflect NIE Networks' likely future long-term pay awards.

5.59 NIE Networks' assumption that salaries will remain relatively stable will decrease the reported scheme liabilities and therefore improve funding levels. However, it is important to note that the Company will be responsible for meeting any future shortfall on the Salary Strain Mechanism. We will continue to monitor this mechanism and its appropriateness.

5.60 NIE Networks have not proposed any salary strain costs for RP6 and we are not making any allowance for such costs.

Longevity

5.61 The longer a pension scheme member lives after retirement, the greater the cost of providing a defined benefit pension. Ongoing funding valuations require an assumption regarding the assumed longevity of members and their dependants. Such assumptions should reflect the particular membership of the scheme e.g. members' industry or geographical factors and should allow for expected future improvements in longevity.

5.62 The assumed expectations of life from the NIEPS's 2009 and 2012 valuations were lower than for most other schemes, being around the 5th percentile of the Pensions Regulator's data in the relevant years. The assumed expectations of life at the 2014 valuation were broadly in line with most other schemes. The report on the 2014 NIEPS valuation states that the mortality assumptions were updated to 'reflect the

Scheme's pensioner mortality experience and postcode analysis since the last valuation;' and that the future improvements were updated to 'reflect the latest research'.

5.63 The 2014 valuation of the NIEPS assumes that longevity will improve in the future in line with the Continuous Mortality Investigation (CMI) 2013 core projections published by the actuarial profession, with a minimum rate of improvement of 1.5%. The Pensions Regulator[22] data indicates that over 90% of DB schemes were basing their assumed mortality improvement rates on CMI projections, for valuations with effective dates between September 2013 and September 2014.

PPF Levies

5.64 In addition, NIE Networks pays the NIEPS's Pension Protection Fund (PPF) levy (refer to glossary for definition details). The scheme is required to pay a levy; the amount has been between £250,000 and £300,000 a year from 2012 to 2014.

5.65 Whilst the PPF levy represents a relatively small proportion of the cost of financing a pension scheme, we would still expect NIE Networks to take steps to reduce the annual amount payable.

5.66 We note that NIE Networks' RP6 submission states that a bespoke investment stress test and deficit reductions contributions certification (DRCC) were submitted through the Pension Regulator's Exchange website. We would expect to see such steps being continued in future and for the scheme to explore other ways in which levy might be reduced (for example using asset backed contributions, which take account of contingent assets pledged to the pension scheme).

Augmentation of Benefit Cost

5.67 Additional contributions of £0.9 million – above the specified normal and deficit contributions – were payable by Powerteam Electrical Services (PES) during the RP5 period. These contributions were payable in respect of benefit augmentations granted during the review period at the point when PES ceased to participate in the NIEPS on 24 December 2013. The contributions were used to enhance the benefits of six active members who were employed by PES.

5.68 We are not aware of any unfunded relevant augmentation of benefit costs in relation to RP6 or RP5 and are not making any adjustments in respect of these costs.

[22] 'Scheme Funding Statistics' Appendix (tPR), June 2016 – Table 5.5

UR allowances to 2022 and 2022-24

5.69 For RP6 we are including an allowance for NIE Networks' final two years of RP6 in line with the RP6 Business Plan request and reviewing this allowance at RP7 following the review of 2017 and potentially 2020 triennial valuations to determine whether these funding requirements are merited and required. It may be appropriate at that point to remove and adjust for the allowances provided in RP6 for the 2022-2024 period. We will include a negative adjustment in the event of the pension scheme being in surplus in RP7.

6 Pension Scheme Expenses

Level of admin and investment expenses incurred

6.1 Additional employer contributions of £77,500 per month are payable to cover administration expenses. We have compared the annual level of administrative and investment expenses incurred by the NIEPS between 2012 and 2016 with data published by the Pensions Regulator. The expenses data is classified according to scheme size to enable a more informative comparison (larger schemes are expected to have lower per member expenses charges). Accordingly, NIEPS expenses are compared with expenses incurred by schemes of a similar size; that is with very large schemes (over 5,000 members) and large schemes (between 1,000 and 5,000 members).

6.2 Figure 6 below compares the cost per member for total administrative and investment management charges.

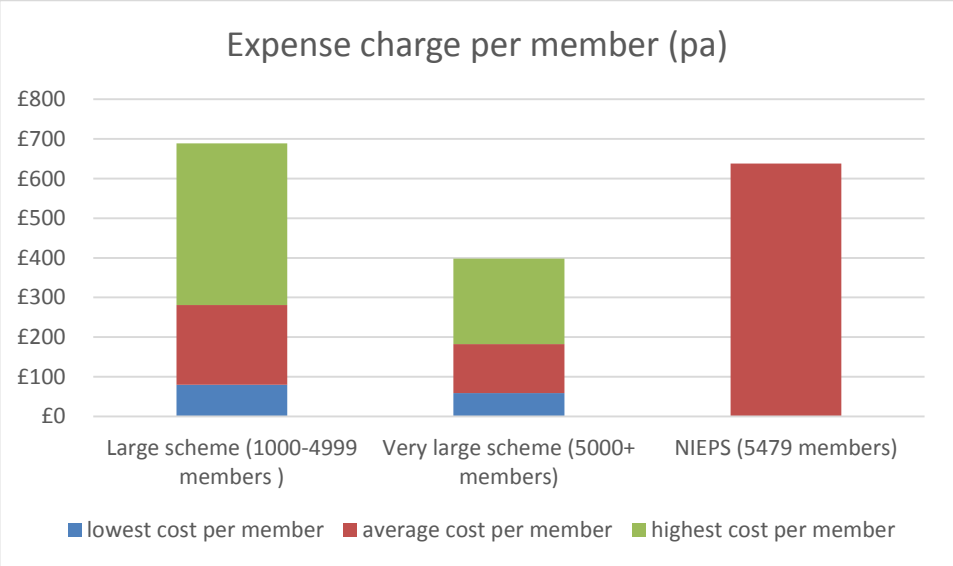

Figure 6: Expense charge per member

6.3 As can be seen from Figure 6, average NIEPS expense costs appear high when compared to the sample data, noting that:

- NIEPS expense costs exceed all those within the sample of very large schemes, and
- NIEPS expense costs are close to the level of the highest individual scheme cost within the sample of large schemes. NIEPS expense costs

are significantly higher than the average ‘large scheme’ expense costs (£638 per member versus £281 per member).

6.4 We note that the investment management expenses appear to represent a relatively high proportion (73%) of the total.

6.5 We note that the trustees’ role will involve monitoring expenses regularly to ensure they are reasonable and governance processes should be in place to ensure this happens.

7 UR RP6 FD allowances

UR approach to FD RP6 allowances

7.1 We have considered NIE Networks Business Plan Submission including its PDAM methodology submission in addition to a range of other material in formulating our approach to RP6 including regulatory precedents, CC RP5 decision and other relevant material. Since the Draft Determination we have considered consultation responses, representations made by NIE Networks, relevant pension aspects and other factors in coming to our Final Determination. Below we summarise our decision on key pension aspects.

Deficit separation methodology

7.2 We have decided that it is appropriate to use the CC methodology to allocate a deficit cut-off date of 31 March 2012 and that the pre cut-off fund as being the consumers responsibility and the incremental post 31March 2012 fund as being shareholders responsibility.

ERDC disallowance

7.3 We can see no reason to change the 30% disallowance in relation to deficit recovery payments in respect of ERDC as set by the CC and proposed by NIE Networks in its Business Plan Submission. We are therefore retaining the 30% ERDC disallowance.

Regulatory Fraction

7.4 We have decided to not adjust the Regulatory Fraction for RP6 to that proposed in NIE Networks' Business Plan for the FD. However, we will monitor its calculation and value going forward and may adjust this in the future – in particular if we consider it to be in consumers' interests.

Transmission and Distribution split

7.5 We are content to apply the Transmission and Distribution splits used by NIE Networks within its Business Plan and the PDAM to allocate the costs between the Transmission and Distribution elements of the business.

Allowances to 2022

7.6 We are including the allowances set by the CC in respect of deficit recovery payments from 2017 to 2022 in line with the amounts outlined in the CC FD with inflationary amounts added.

Methodology 2022-2024

7.7 We recognise that the current funding position may have worsened compared with expectations at the 2014 valuation – largely due to the performance of the scheme assets not keeping pace with the increasing value of the liabilities – however, fluctuations in the funding position (positive or negative) will happen in practice, and it is not certain that deficit contributions beyond 31 March 2022 will be necessary.

7.8 Recent funding updates show that the NIEPS pre-cut off date subfund is still in deficit and it is still the consumers' responsibility. It is a matter of timing as to whether it is paid over a longer or shorter period and we must also be mindful of intergenerational equity considerations. It is unclear as to whether pension scheme deficit recovery payments should continue to be made post the 2022 period at similar levels as those set by the CC. The scheme is still facing a substantial deficit despite the fact that recovery payments are being made in line with the CC allowances, largely due to the changes in gilts rates.

7.9 The request for extra contributions is mainly a timing point; the deficit in the pre-*cut off date* subfund will be funded by the consumer so all else being equal, higher contributions now will lead to lower contribution in future and vice versa. However, we are mindful of the need to protect consumers and encourage the company to manage its pension scheme in as efficient a manner as possible.

7.10 For the last two years of RP6 covering the period 1 April 2022 to 31 March 2024 we are including NIE Networks the amounts proposed in its business plan submission subject to the outcome of the next triennial reviews at 2017 and 2020 (and 2023 if available). At RP7 we will make a more informed decision as to whether these deficit recovery payments are required or should be adjusted. Any repayment will be in NPV neutral terms.

Treatment of Surpluses

7.11 We require NIE Networks to take appropriate action in the event of the pension scheme becoming into surplus and ensure the consumer benefits from any surplus. NIE Networks should indicate to the UR in a timely manner should the pension scheme be in surplus or whether NIE Networks considers it will be in surplus in the foreseeable future and make appropriate proposals to benefit the consumer.

7.12 We present our FD allowances based on the above assumptions in the table below and note that the deficit recovery allowances are included until 2024. However, the

amounts included in the last two years of RP6 will be considered at RP7 and may be adjusted in NPV neutral terms dependent on recent triennial valuations and deficit funding requirements. We will make a negative adjustment to the 2022-24 years in the event of the scheme being in surplus.

	RP6 Request £m	RP6 FD £m
Pension Deficit Contribution	114.5	114.5
Pension ERDC disallowance	(30.5)	(30.5)
Net Amount Requested	84	84

Table 12: UR FD pension deficit recovery (2015-16 prices)

7.13 This results in an annual profile as follows:

	10/2017-03/2018 £m	04/2018-03/2019 £m	04/2019-03/2020 £m	04/2020-03/2021 £m	04/2021-03/2022 £m	04/2022-03/2023 £m	04/2023-03/2024 £m
Pension deficit funding	8.804	17.609	17.609	17.609	17.609	17.609	17.609
Less Pension ERDC disallowance (£m)	-2.3	-4.7	-4.7	-4.7	-4.7	-4.7	-4.7
RP6 pension allowance	6.504	12.909	12.909	12.909	12.909	12.909	12.909

Table 13: RP6 Pension FD allowance (2015-16 prices)

7.14 This is split between the Transmission and Distribution sections of the business as per the PDAM allocations as follows:

Split by business	10/2017-03/2018	04/2018-03/2019	04/2019-03/2020	04/2020-03/2021	04/2021-03/2022	04/2022-03/2023	04/2023-03/2024
Transmission	23.64%	23.52%	23.47%	23.54%	23.46%	23.35%	22.82%
Distribution	76.36%	76.48%	76.53%	76.46%	76.54%	76.65%	77.18%

Table 14: Transmission and Distribution business splits for pension allocations

Efficiencies

7.15 We note that following the introduction of the PDAM framework, NIE Networks' interests are arguably more aligned to consumers now as its shareholders are fully responsible for any surplus or deficits in the post cut-off date subfund. However, we expect NIE Networks as an efficient employer to continually monitor and implement mechanisms for cost savings in relation to pension scheme aspects.

7.16 In respect of the *established deficit*, we note that NIE Networks' ability to manage the deficit is limited due to Protected Persons legislation and the scheme's mature membership profile, however it would be reasonable to expect an efficient company to explore any opportunities to mitigate unnecessary costs by considering an increase in member contributions or reforming scheme benefits (for staff who are not subject to Protected persons legislation).

7.17 We note that no allowance has been made for an 'inflation risk premium' which could arguably be incorporated into the valuation assumptions (on the basis that breakeven inflation used at the 2014 valuation would, all else being equal, be expected to slightly exceed the future change in the inflation indices). Allowing for such an adjustment might be expected to reduce the assessed value of the liabilities by perhaps up to 5%.

7.18 Going forward, we expect NIE Networks to work in conjunction with the trustees and relevant advisers to reduce pension costs as far as possible.

8 Monitoring of Pension Scheme Funding

Pension Monitoring Framework (PMF)

8.1 We are introducing a 'Pension Monitoring Framework' to ensure that NIE Networks only approaches the Utility Regulator when it is clear that there has been a substantial fall in the NIEPS funding position at triennial valuations during RP6, which in turn could lead to the possibility of materially higher deficit contributions. Conversely, to ensure a symmetric approach, this framework should also include an 'upside' PMF when the pension scheme funding has improved.

Operation of PMF

8.2 It is intended that these levels would act as a basis for initiating a discussion between NIE Networks and the Utility Regulator before the end of RP6. We would not consider a simple mechanism for automatic actions to be appropriate as it will not fully account for changes in future circumstances. Action(s) could then be taken as appropriate in light of the circumstances at the time.

8.3 Whilst the application of a 'simple' framework will not allow for all relevant considerations at future valuations, it is not appropriate for the Utility Regulator to be involved in extensive valuation discussions (covering changes in assumptions, investment strategy, recovery period covenant assessment etc.) during RP6 unless they are essential and not simply reacting to current events.

8.4 We recognise that funding a pension scheme is a long-term commitment and sponsors should not over-react to short-term fluctuations in the scheme's funding level (such short-term fluctuations are currently almost inevitable). Further, in NIE Networks' case, any NIEPS deficit in respect of pre March 2012 accrual is fully supported by consumers so the provision of deficit contributions would mainly be a timing point, and actual contribution payments during RP6 would be subject to review at RP7.

8.5 We also note that NIE Networks have a significant advantage over many non-regulated companies which are similarly exposed to the risk of unexpected higher costs related to legacy DB pension scheme deficits. However, such non regulated entities will not automatically have the option of passing on higher costs to customers.

8.6 We recognise that determining PMF level points may involve a degree of subjectivity; however, the UR will assess each application on its own merits. We have considered assessing the scheme funding level at future valuation dates (31 March 2017, 2020 and 2023) using the 2014 valuation basis (updated for market conditions, e.g. gilt yields, but maintaining the same margins for prudence) as a benchmark to assess against the suggested points. In other words, carrying out funding level assessments in line with the approach reflected in Aon Hewitt's funding update to 31 December 2016 (dated 27 January 2017). In determining whether suggested levels have been reached it is imperative that pension scheme valuations and funding levels are conducted in a consistent manner.

8.7 These PMF events should be very rare by their nature. Such events should be significant and represent a marked fall in funding levels. For example, in Table 2.1 of the Scheme funding statistics (tPR data) we can observe the largest fall in technical provisions (TP) funding ratios between tranches 3 and 4 (a 12.3% annual drop in funding (86.3% to 74.0%) – around the time of the 2007-08 global financial crisis).

8.8 We note that the 2014 triennial valuation resulted in a funding level of around 85%. At the DD we proposed that a reduction in funding levels to 70% would represent a downward event – however, each event will be analysed on their individual merits. By contrast at the DD, we proposed a level of 110% pension scheme funding to be appropriate for an upward event.

8.9 Following our DD consultation, NIE Networks responded that these thresholds may be too low for the downward mechanism and too high for the upward mechanism and that levels of 70% and 100% would be appropriate. We have considered NIE Networks' response and consider a threshold of 80% funding may be too high and consider 75% to be more appropriate as it would represent a more extreme funding position which would be less likely to be breached. In addition, we also consider the threshold of 100% may be too low and 105% may be appropriate as at a point of 100% the assets would exactly equal liabilities and there should be a slight level of headroom above the point of the scheme being fully funded to initiate discussions.

8.10 Therefore, we are setting a downward threshold of 75% and an upside threshold of 105% for the PMF to initiate discussion between the UR and NIE Networks in relation to pension scheme funding.

8.11 The PMF may be activated, either by the company and/ or the Utility Regulator. The Utility Regulator will consider funding levels and pension scheme characteristics and future outlook to determine whether or not any adjustment is required to e.g. funding levels, deficit recovery payments (either up or down), bill adjustments, etc.

Adjustment of pension scheme funding- Licence Mechanism

8.12 There is a mechanism for adjusting pension scheme funding at price control reviews by considering whether any adjustment is required in respect of the pension contributions allowed at the previous price control. In addition, NIE Networks'

Transmission and Distribution licences provide adjustment mechanisms which are outlined below.

Licence treatment of pension deficit

8.13 Pension deficit amounts may be adjusted via the Maximum Regulated Distributions Revenue (MRDR) in accordance with NIE Networks' licence in Annex 2. There is a separate calculation for the Maximum Regulated Transmission Revenue which is a mirror image of the MRDR but for the Transmission business. The MRDR is defined in the licence as follows:

The Maximum Regulated Distribution Revenue for the Regulatory Reporting Year - RP5Rt

8.14 3.5. For the purposes of paragraph 3.3, the Maximum Regulated Distribution Revenue for the Regulatory Reporting Year t shall be calculated as follows:

$$RP5Rt = DEPt + RETt + BDt + Ot + Pt + COI_t + TAXt - RPSI_t + Kt$$

Where:

***DEPt** means the depreciation amount in Regulatory Reporting Year t, calculated in accordance with paragraph 4;*

***RETt** means the return amount in Regulatory Reporting Year t, calculated in accordance with paragraph 5;*

***BDt** is the allowed opex amount (if any) in Regulatory Reporting Year t, for Uncollected Revenue, being the amount appropriate for the Licensee to recover in that Regulatory Reporting Year, in respect of Uncollected Revenue, less any amount or part of an amount treated as Uncollected Revenue in respect of a preceding Regulatory Reporting Year t that has been paid to the Licensee in Regulatory Reporting Year t;*

***Ot** means the opex amount in Regulatory Reporting Year t, calculated in accordance with paragraph 6*

***Pt** means the pension deficit amount in Regulatory Reporting Year t, calculated in accordance with paragraph 7;*

***COI_t** means the costs of the investigation amount in Regulatory Reporting Year t, calculated in accordance with paragraph **Error! Reference source not found.**;*

***TAXt** means the tax amount due in Regulatory Reporting Year t, calculated in accordance with paragraph 9;*

***$RPSI_t$** means the revenue protection services incentive amount, in Regulatory Reporting Year t, calculated in accordance with paragraph **Error! Reference source not found.**;*

Kt *means the correction factor amount (whether a positive or negative number) calculated in accordance with paragraph 11.*

8.15 We highlight that the adjustment for pension deficit amount can be a positive or negative amount and can provide a mechanism for adjusting pension deficit amounts in the Maximum Regulated Revenue for the Transmission and Distribution businesses.

8.16 Further the pension deficit amount is defined in Article 7 of Annex 2 to NIE Networks' licences. For RP6 we be making modifications to define the new pension amounts for the financial years of RP6 using a 2015-16 price base in both the Transmission and Distribution licences. This will be done through our licence consultation which may be accessed at www.uregni.gov.uk .