Cemil Altin Esq.
Head of Price Control Development
Ofgem
9 Millbank
SW1P 3GE

29 August 2003
TLEG43 – Altin

Dear Mr Altin

DEVELOPING NETWORK MONOPOLY PRICE CONTROLS

I refer to the OFGEM Consultation Paper of June 2003 – Developing Network Monopoly Price Controls - and our telephone conversation on 22 August 2003. I herewith enclose a paper from Prospect for your consideration.

I understand that despite missing the official deadline of 22 August 2003 for receipt of responses, you will arrange for views to be considered.

Thank you for your assistance in this matter. A paper copy was placed in the post today.

Yours sincerely

Terry Lane
Deputy General Secretary

enc

DEVELOPING NETWORK MONOPOLY PRICE CONTROLS - SUBMISSION

I refer to the consultation document of June 2003 and write on behalf of Prospect comments on the document which we would like you to take into consideration.

Prospect is a trade union, formed in November 2001 by merger of the Institution of Professionals, Managers and Specialists (IPMS) and the Engineers' and Managers' Association (EMA). We represent 105,000 scientific, technical, managerial and specialist staff in the Civil Service and related bodies and major companies. In the electricity supply industry we represent engineers and other professional specialist staff employed in generation, transmission and distribution. We were fortunate in being able to draw on members' direct operational and technical knowledge and experience to inform our assessment.

GENERAL PRINCIPLES

Prospect recognises that the key to effective regulation lies in a creditable framework which is transparent easily understood and capable of being consistently implemented across the sector. We believe that the framework should be structured in a manner to cater for a degree of flexibility to enable companies to meet the inevitable unforeseen circumstances which will arise in any reference period. To recognise these unquantifiable variables the framework should not be a set of rigid rules requiring companies to inter alia reopen negotiations with the regulator every time an unforeseen event creates an uncertainty. There must be an element of allowance for uncertainty within any price control mechanism.

Past price control mechanisms have focused primarily on limiting expenditure so far as possible leaving DNOs to meet unexpected events from their existing resources. The government's recent Energy White Paper has signalled a number of uncertainties that will inevitably arise during the reference period. New regulations will be imposed by the

Environment Agency, Health and Safety Executive etc. Even at this stage we do not know the capacity or location of renewable generation sources that are likely to be connected to the system. Such demands will have an uneven impact on DNOs capital expenditure programmes. Each will require investment in network strengthening with all probability that the cost of meeting the unforeseen demands for capital will be adversely detrimental to a number of companies, unless there is flexibility within the system.

Similarly to accommodate anticipated expansion of other non-traditional methods of generation such as distributed generation these too will also impose upon companies a demand for unplanned network improvements. We believe an opportunity should be taken at this time to enable companies to grasp the opportunities presented by the expansion of these anticipated but uncertain developments. Such developments will be complementary to but in support of the government's environmental targets, as well as improving the quality of supply and network reliability to end users.

Capital costs associated with work of such nature should be reflected in the price control mechanism. Companies must be permitted to pass on some savings to electricity users retaining some of the efficiency gains themselves. Incentives to manage costs and deliver the anticipated outputs must be a key operational principle provided that the mechanism is easily understood and fairly applied.

In the past Prospect has been suspicious of the use of benchmarking as a tool to drive down costs because it has been applied secretly. Lack of transparency has led to the belief that the only goal was to bring down the product price regardless of other operational consequences. External benchmarking may have an acceptable role if the measures and/or comparators to be used make informed judgements about real life realities, rather than conclusions simply based upon artificial theory. Incentives derived from these methods and properly applied would spur companies to create efficiencies. If each company were given an individual allowance to meet their own costs, the general impact of initial higher returns for some companies would be mitigated as a balancing of rewards to the efficient followed by the less efficient companies. The benefits would be smoothed across the sector. In this way customers would continue to benefit from the force of better regulation during the reference period.

Against this background Prospect has arrived at the conclusion that an average cost methodology is probably the most favourable option in terms of both reasonabless and fairness. Historically it has been the more efficient companies that have pushed forward the barriers enabling the Regulator to establish targets for the remainder of the sector.

CAPEX

WE WELCOME THE DTI'S INTEREST IN THE LESSONS TO BE LEARNED FROM THE 2002 STORMS AND THE ACCEPTANCE OF THEIR VIEW THAT THESE SHOULD BE REVIEWED AS PART OF THE PRICE CONTROL REVIEW. IT REMAINS OUR FIRM VIEW THAT INFLEXIBILITY IN THE PRESENT SYSTEM AS WELL AS THE INCESSANT PRESSURE TO REDUCE COSTS HAS ULTIMATELY EXPOSED THE STRENGTH OF OUR LONG HELD AND FREQUENTLY STATED BELIEF THAT PROGRAMMES OF CONTINUOUSLY CUTTING STAFFING COSTS WOULD HAVE A NEGATIVE IMPACT OF THE STANDARD AND QUALITY OF SERVICE TO THE CUSTOMER.

We recognised that sound investment will bear its own reward. An allowance must be made for DNO's to invest in good personnel. Investment in staffing by most DNO's appears to be woefully inadequate. There are several well respected and widely supported independently researched papers that have been published identifying the difficulties faced by companies in the sector over the recruitment of people holding science technical engineering or mathematical skills. Without a suitable skilled workforce DNOs are unlikely to meet unsatisfactorily meet the new demands to be placed upon them, in areas such as the anticipated growth in the number of new connections to the network. This sector will require people with a wide range of skills associated with an expanding high-tech industry where developments in the new technologies of the future will be stifled resulting in government's policies facing an uncertain future. It is now opportune to provide suitable flexibility within the price control mechanism to enable DNOs to expand, refresh and restock the skill base of core employees. In our view incentives investment will be best served by the rolling RAV approach. This would ensure for example that efficiency savings could be used for the recruitment and retention of an adequately trained workforce with the skills necessary to provide a reliable service to customers.

Prospect recognise that there are many pressures upon operational costs incurred by companies ranging from a myriad of consequences from increased competition to reluctance of land owners to give access to enable simple vegetation growth control activities to be undertaken. Each feature gives rise to unwelcome increased costs. We believe that a greater expenditure to meet some of these challenges will ultimately result in a longer term gain to the customer if an opportunity were to be taken to measure and evaluate the varied geographical areas on which DNOs operate. By taking into account the territory in which these companies serve, assess in an objective, fair and consistent manner the differences faced by the companies operating in an urban or rural environment. It should be possible to facilitate the development of a mechanism to deliver benefits to the customer in terms of improved reliability and security of the network. The companies would benefit through the efficiency of the committed workforce who themselves would bring long term benefits to the customer through the utilisation of their skills and knowledge.

COMPETITION AND FUTURE COSTS

Prospect recognises that previous price control reviews have focussed on efficiency through competition but it should also be borne in mind that competition brings additional costs. As fledging businesses flourish some of the traditional work undertaken by DNOs is lost to a competitor. Not only are customers and revenues lost but staffing numbers are reduced. The loss of experienced and trained staff available to meet unanticipated events-specifically system emergencies- damage customer’s interests. This was recognised by the DTI following their enquiry into the 2002 storms where the structure of some companies mitigated against customers immediate interests. It is, therefore, absolutely vital that account is taken during the course of this price control review of practical operational realities essential in providing an efficient and effective service to customers.

Providers of funds for investment purposes demand a stable regulatory regime that assures them, of, so far as reasonably practical in a low risk industry, a reasonable expectation of a return on their investment. For these reasons assumptions about performance of the system to deliver an acceptable level of service must be reflected in the funding determined by this price control with flexibility to observe uncertainties. This should not be an opportunity to impose unrealistic cost reduction expectations where a merger or acquisition arises or indeed impose some form of special adjustment from such circumstances simply to reduce costs. There comes a time when draconian cost reductions simply push a service below economic levels but at the same time there has to be a facility for companies to maintain sufficient cash flows within their businesses to enable them to retain investor confidence.

TREATMENT OF PENSION FUND COSTS

In general terms we support the principle that funding of pension costs should be reflected in the future price controls provided always that the outcome is seen to be fair; the mechanism has been consistently applied; the role of the trustees as well as their rights and responsibilities and the current pension legislation is recognised. Specifically we think it is worth reflecting on the views previously expressed by respondents. The investment policies of each group of the Electricity Supply Pension Scheme (ESPS) are governed by decisions taken by Group Trustees on the advice of professional investment advisors. Each group publicises his own investment strategy to meet his own perceived funding requirements in accordance with the demographic profile of their Group.

Similarly, individual DNOs have in the past independently taken their own decision to accept a pensions holiday or offset pension surpluses against redundancy costs as a response to their own immediate financial needs.

Prospect believes that the true pensions comparators should be the existing or former public sector companies operating defined benefits schemes. The roots of the ESPS are in the public sector where there is a service ethos. The Electricity Distribution Sector is not and never has been compared to the Engineering or Manufacturing Sector.

We agree that it is appropriate for pension costs to be funded through the price control mechanism but the companies who use or in the past have used pension fund surpluses to finance the reduction of core staff should not be permitted to "pass through" these costs to customers.

Prospect welcomes the proposed establishment of guidelines relating to the use of pension costs. However it is recognised that customers of network monopolies should and do pay for the efficient cost of providing a competitive package of employment benefits. OFGEM has historically borne down on these costs benchmarking against unpublished consultants advice. In that sense the principle has already been widely accepted that the cost of providing benefits for employees is reflected in the price of the product charged by DNOs.

We agree in principle that within the price control mechanism there should be an allowance for the cost of providing pension benefits accruing during the period of control. However, it will be imperative to ensure that any allowance has the full and total agreement of Trustees of each Group of the ESPS coupled with the use of a common set of actuarial assumptions. In this connection it should be noted that there are different valuation dates for the English and Scottish companies, and a wide variety of previously published investment strategies carefully constructed against the background of independent financial professional advice. Plus a recognition of legal obligations imposed by the Electricity Act 1989.

If pension costs are to be assessed in an objective manner the processes must be carried out on the basis of an agreed set of actuarial assumptions set by a professional body rather than an individual commercial actuarial practice. Our most recent historical experience persuades us that a period of some six months will elapse between the triennial review date and the issue of the actuarial report along with recommendations to group trustees. Thereafter publication to scheme members takes a further three months.

Notwithstanding the current rolling programme of actuarial reviews taking place within each group of the ESPS, we are concerned at the possible effects of moving the valuation date forward on the funds, simply to conform to the OFGEM's imposed distribution price control period. Our previous point regarding different valuation dates for the Scottish and England and Wales schemes also refers.

There is also a further potential conflict here. The role of the trustees; requirements of pensions legislation as well as the specific provisions of the Electricity Act 1989 including those relevant to protected persons must not be overlooked and should be carefully considered.

It is now broadly accepted that pensions are deferred pay and as such employees have a right to their voice being heard as the implications for this proposal evolve.

Prospect would wish to be consulted in advance on any proposals emerging from the discussions with companies, actuaries and other stakeholders. Prospect represents many thousands of contributing, deferred and pensioner members whose voice should be heard by their accredited representatives to eliminate any suspicion of self interest however remote that might be.

We also think there should be a clear distinction between the costs that arise to companies from " ……resulting from poor management" and ..…."resulting from poor investment". Any costs arising from the unforeseen poor returns as a result of an investment decision that failed to yield anticipated benefits, should be permissible as a "pass through" cost to be borne by customers. We would argue firmly that this is a case for making a provision for an "uncertainty" with customers bearing the risk. Such circumstances are totally different from costs which arise from poor management where we would agree they should not be borne by customers but by shareholders.
Properly managed pension costs should mean less money is spent on administering pensions. Therefore greater sums can be available for diversion to the urgent need to fund employment expansion to meet the universally accepted skill gaps.

We recognise the proposition that pension benefits that do not relate to the regulated business should not be taken into account in assessing permissible costs. We have some concern with the proposal put forward in relation to assessing the liabilities in respect of pension provision benefits that do not relate to these businesses. We think it would be extremely difficult to operate such a regime in a fair and transparent basis. This would mean "stripping out" from existing funds the liabilities accruing to fund members engaged outside of the regulated business. We would doubt the reliability of the historic evidence available to companies to ensure that this would not become an endlessly controversial proposition.

Similarly Prospect would oppose the suggestion to claw back any benefit that the companies may have derived from a misallocation on the occasion of past price control reviews.

We have some sympathy with the proposal that the custom and practice in the treatment of pension liabilities in mergers and acquisition markets might provide an acceptable basis to carry forward these ideas. However, caution needs to be exercised. Pension

Fund Trustees presently find that there are a range of actuarial options presented to them when reallocating the liabilities for employees who are transferred to the pension scheme operated by the new owner, even where the scheme itself is part of the wider ESPS family.

Prospect certainly supports the principle that companies will be expected to absorb the increase in the costs of providing enhanced pension benefits granted under severance terms where these are used to restructure businesses. In some cases these enhancements have been funded through the use of the employers share of surpluses available at that time. It should be recognised that there is a legal obligation on Trustees to dispose of surpluses in accordance with Inland Revenue regulations. In some cases companies have used their share of a pension fund surplus simply to enhance the financial standing of the company who in turn make parallel payments to pensioners in the terms of one off lump sum payments. We agree that companies who have acted in this way and who have used surpluses to fund restructuring should not be permitted at this stage to take the opportunity to ask customers to fund past management decisions which with the benefit of hindsight have, partially resulted in a requirement to fund a future unanticipated pension fund deficit.

Prospect supports in principle the proposals set out in the paper. We suspect that the ambition may be tempered by inadequate unreliable and in some cases unavailable records. In addition, of course, the time and resource needed to be devoted to produce a fair, transparent and consistently applied mechanism would provide a benefit disproportionate to the costs involved.

29 August 2003

TL/EG