

ELECTRICITY DISTRIBUTION PRICE CONTROL REVIEW UPDATE 124/03

Introduction

1. Prospect is a trade union formed in November 2001 by the merger of the Engineers and Managers Association (EMA) and the Institution of Professionals Managers and Specialists (IPMS). 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 a large proportion of engineers, managers, technicians and other professional specialist staff employed in generation, transmission and distribution.
2. We welcome the opportunity to submit further evidence as part of the collection of contributions to the review of the Electricity Distribution Price Control Review Mechanism.
3. Prospect put forward two detailed submissions in response to two earlier consultation papers issued by OFGEM. We are currently awaiting an opportunity to meet with officials to discuss our views. We acknowledge that some of our opinions do appear to have been recognised. Therefore, we do not feel that it is appropriate at this stage to reiterate all our previously stated opinions. Our comments concentrate on specific key aspects of the latest consultation document. These are those of greatest significance to us and the thousands of people who rely on an effective and efficient electricity sector for their employment as well as the interests of the customers who benefit directly from the professionalism and dedication of all DNO employees.

Form, Structure and Scope of the Price Controls

4. We note the views expressed concerning the application of the RPI – x formula. It is our view that this formula which extracts cash from companies cannot continue forever. Prospect would welcome a statement from OFGEM to the effect that during the period leading up to the review post April 2005 an opportunity will be taken to examine alternative methods of incentive regulation in the future.

CAPEX Adjustment

5. We welcome the concept of flexibility. In support of transparency we believe it will be appropriate for the mechanism used to measure efficiency savings or overspends to be open to public scrutiny to ensure that all interested parties can be assured that the mechanism has been fairly applied to all DNO's.

Distribution Loses

6. Prospect fully supports realistic attempts to reduce system loses. We have noted the initial proposals to emerge from the detailed examination of the issues. We would, however, point out that there could be an unintended contradiction in the efforts to eliminate technical loses where these arise out of illegal extraction of electricity. We do not believe there should be an incentive element to police revenue losses caused by illegal extraction. This should be a natural commercial function which need not and should not be incentivised.

Quality of Service and Other Outputs

7. Whilst we welcome OFGEM's work in developing criteria to compare quality of service performance we are concerned that this does not appear to take into consideration performance achieved under very differing conditions. We believe an account should be taken of the significant differences between the achievement of benchmark levels of performance under normal trading conditions and those met in exceptional circumstances. The so called "frontier performers" do not necessary achieve "frontier performance" under every operational condition.
8. Prospect would welcome an assurance that these variables have or indeed will be taken into account when setting benchmarks by comparing similar parts of the networks and comparing performance under differing conditions.

Network Resilience

9. In the evidence submitted to the 2002 government's energy policy review Prospect noted that the current system of regulation inadvertently encouraged companies to avoid investment in underground distribution networks and risk power cuts every now and then. The penalties for this are minimal so long as each company's performance is not poor by comparison with it's peers so losing very little by doing this. What is lost during a power cut will be more than offset by savings in investment and maintenance. However, we think this is essentially a short sighted approach.
10. We agree with the incentivisation of companies to enable them to invest in providing a distribution network which is more resilient as the appropriate pathway forward. The price control formulas of the past have imposed upon companies a regime which has led to a substantial decrease in staffing levels. These decreases have not been totally matched by improvements in technology to support increases in efficiencies. To meet cost targets DNO's have:
 - Reduced staffing levels despite the need for higher levels of reliability.
 - Reduced the proportion of highly skilled engineers employed in operations.
 - Reduced the numbers of staff available to conduct inspections of operational plant.
 - The increased reliance on less experienced contractors staff to undertake work with poorer levels of supervision.
 - Extended maintenance frequencies.
 - Deferred maintenance to secure a better utilisation of a smaller workforce.

11. A direct result of these policies has been: -

- Less than sufficient resources to meet system emergencies caused by severe weather and other exceptional circumstances.
- An increase in the number of faults which have arisen from extended maintenance frequencies as well as through the employment of lower skilled staff.
- A lower level of capital expenditure.
- Revised patterns of employment with reductions in core employees to meet the demands which has resulted in an inferior level of service to customers.

12. In effect previous distribution price control reviews have incentivised DNO's to increase operational risk – often against the technical judgement of professional staff – by the simple mechanism preventing DNO's operating under their former methods of working.

13. In practice OFGEM have had considerable freedom to determine what combination of goals best serves the public interest. From the mid 1990's OFGEM has focussed on cost reductions in response to a need for increased efficiency in operational areas. Whilst cost efficiencies resulted from this process very little value appears to have been placed on the need to consider the impact on the operational activity through a restrictive approach to operational expenditure. The failures of these policies have been in evidence by the performance of several DNO's in meeting the operational exigencies created by the 2002 storms.

14. This view has been confirmed by the report of British Power International (BPI) on the October 2002 storms who indicated that in their opinion DNO's could improve their storm performance within the existing operating parameters.

15. Prospect welcomes the suggestion, that in the future, it should be open to particular DNO's to choose the most efficient approach in meeting these challenges rather than through the imposition of specific targets to meet operational needs.

16. We note that OFGEM has engaged consultants to advise on these matters but would welcome an opportunity to share our views on behalf of those who's daily task it is to maintain an effective and efficient operation of each distribution network throughout the UK.

Distributed Generation

17. Prospect welcomes the acceptance of the proposal to establish an incentivised framework for distributed generation. Our base concern is that there remain a number of uncertainties and unpredictabilities over the pace of development and expansion of distributed generation. We note these views appear to be shared by DNO's.

18. We would reiterate a previous view that DNO's should be incentivised to manage distribution losses. However, we can envisage the situation where a small scale distributed generator can reduce losses and where a large scale distributed generator who exports to one or more other DNO's can cause an increase in costs through additional power flow losses.

19. DNO's distribution losses are paid for by its load customers only but we cannot see that there is a logical reason why distributed generators should not accept a fair share of these costs. There should be a level playing field for all generators regardless of the method of generation. Costs should be reflected in the energy price paid by the supplier and the customer alike.
20. Prospect has noted the key cost drivers for distributed generation set out in table 5.2. We wish to point out that the impact of the second bullet point in the voltage limits cost driver VIZ: "using voltage control equipment such as automotive voltage regulators"; could imply reduced system flexibility and consequent losses. The most recent visible demonstration of the effect of this and indeed the potential for disruption that can arise can be seen as a result of the power failures experienced by Londoners in August 2003.

Assessing Costs

21. We note that OFGEM will be commenting further on the issue of comparability. It is our view that the only strict comparators are those engaged in the process of distributing electricity in the UK. The comparators must be those engaged in the activity of distributing electricity who together face similar or identical challenges to deliver to customers a reliable electricity service at an acceptable price. Each DNO is faced with the regulatory regime imposed by OFGEM. Each accepts the imperfections of the price control mechanism and these are simply not present in any other industry or sector of the UK economy.
22. For this reason Prospect will be examining very closely the CEPA report on Total Factor Productivity to be published shortly, given that CEPA's remit from OFGEM aims to incorporate these wider comparisons against DNO's performance. Whatever benchmarking and TFP approaches are finally used, transparency (including the publication of consultants reports) will be essential. Prospect welcomes OFGEM's statement in paragraph 6.22 in this respect.

Finance Issues

Treatment of Pension (and Employment Costs)

23. Prospect welcomes the apparent widespread support for reflection in future price control mechanisms, the cost of providing pay and benefit packages, including pensions. We are disappointed at the absence of any detailed analysis of the manner in which companies will be able to recruit and retrain suitable qualified staff.
24. We reiterate our previous view that this should be available for scrutiny by all stakeholders.

Benefit Enhancement

25. We do not believe that it is entirely accurate to suggest that companies were not in a strong position to control total costs of past redundancy programmes. For the most part the widespread programmes of redundancies were imposed upon DNO's by OFGEM regulatory decisions. It should be recognised that in reducing the size of their work force DNO's operated a "selective" redundancy programme to effect staff reductions. In some circumstances enhanced severance terms were offered by DNO's to encourage employees to leave their employ as quickly as possible.

The aim was simply to reduce the employment cost base of the company. One effect of these policies has been the loss of skilled qualified staff and the resultant difficulties in meeting operational demands. DNO's exercised their own pragmatic management decisions in the light of the prevailing industrial climate at the time. They chose the route and were in a position to control the costs of these policies recognising the very strong campaign conducted by the trades unions' against compulsory redundancies.

26. The overwhelming majority of DNO's were able to use part and in some cases a large proportion of the surpluses which had accrued in every group of the Electricity Supply Pensions Scheme (ESPS) throughout the 1990's to offset the redundancy costs which would otherwise have been met out of revenue. Therefore, the customer benefited because the costs were born out of pension fund surpluses and not directly by DNO current account income.
27. It is our belief that a number of DNO's who were able to secure agreement with their pension scheme group trustees to waive deficiency payments were in the minority. Any such decisions would have only added to the financial risk associated with the consequences of a failure to make adequate contributions to their group of the ESPS (or the equivalent scheme/s in Scotland) in accordance with the scheme rules. In the same way contribution holidays taken by many DNO's during the 1990's have resulted in an underfunding in many of the industry's pension funds. These were management decisions. With the benefit of hindsight they are now shown to have been unwise. It would, in our view, be inappropriate to permit retrospective application of the cost of meeting these past pension fund deficits to meet past service liabilities in those companies where such practices were adopted.
28. Prospect welcomes the OFGEM decision to bring forward detailed proposals as part of a methodology statement.
29. Prospect would also wish to be consulted in advance of any proposals emerging from discussions with group, scheme, as well as independent actuaries, trustees and other stakeholders.
30. Prospect represent many thousands of contributing deferred and pensioner members of the various pension schemes whose voice should be heard by their accredited representatives to eliminate any suspicion of self interest, however remote that might be.

TLEG194 – Distribution Price Control

20 November 2003