

DRAFT**Introduction**

1. Prospect is a Trade Union formed in November 2001 by merger of the Institution of Professional 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 perform our assessment.

Formed Structure & Scope of the Price Controls

2. Prospect generally welcomes OFGEM's approach to the revenue driver process continuing into the future, as well as the maintenance of the five year periods between price reviews. We regard this as an essential recognition of the need to facilitate the adoption of sensible investment and expenditure decisions. In these circumstances we believe it would be appropriate to strengthen the incentive regime to encourage greater investment levels. Converse we do not believe there should be a strengthening of the incentives to encourage cost savings because these would detract from the overall aim of improving the reliability of service provided to consumers. In this respect we agree with the OFGEM analysis.
3. We are not convinced of the argument in favour of strengthening the incentives to achieve "frontier" status. Our judgement is that these issues should be assessed on the basis of an average performer with clear incentives to those companies achieving

above average performance or penalising those who's performance is judged to be below average.

4. We believe there could be difficulties with the concept of delivering "outputs that consumers value". How are these values to be measured or assessed? For example, cost is likely to be a key factor for the majority of consumers but there are or may well be a significant minority for whom less polluting forms of energy are important. Given these key variables, which undoubtedly exist, Prospect believes that in light of the Government's clearly stated ambition to secure a larger proportion of energy supplies from renewable sources it will be inappropriate to reward those companies who failed to improve their infrastructure. It would be necessary to find a mechanism to recognise the contribution those companies who's capital expenditure savings are directly linked to the expansion of renewable sources of energy.

Price Controls for Metering Service

5. We support the concept of establishing a separate metering price control.

Quality and Service and Other Outputs – Refining IIP

6. We do not believe there should be any further tightening of the standards by exempting industrial action. Industrial conflict resulting in some form of action may not necessarily be largely under DNO control. Industrial action within TRANSCO, a generating company, a service company or indeed another DNO can impact upon the service delivery despite the fact that the DNO concerned has absolutely no control over the source of the service delivery failure.
7. We have some sympathy with the proposal to amend incentives linked to consumers willingness to pay. We believe that there is ample anecdotal evidence to illustrate the

fickle nature of domestic and small business consumer's response to surveys enquiring into their willingness to pay for prospective service improvements compared to their final response when they are asked to pay for the improvements they had originally indicated they wanted. Larger business consumers on the other hand are judged to be more reliable in matching improvements demanded and their willingness to pay. For these reasons we believe that consumer service standards must distinguish between the varying types of consumers identified in paragraphs 4.15 – 26 to avoid DNO's facing unforeseen costs incurred in attempting to collect payments from the reluctant consumers.

8. It is our firm belief that the "...backward looking nature of the required assessment of companies performance..." referred to in paragraph 4.28 has arisen directly as a result of OFGEM's past policies. Our preference would be for a reversal of these policies. We favour incentivising companies to encourage them to take the necessary actions to improve network resilience in readiness to meet any unexpected demands created by exceptional events. In this respect whilst statistical information may be instructive, there are cost implications relevant to the nature of the geographical operating territory of the company, planning considerations which seem to differ from region to region etc. A key factor is the availability of skilled and technically competent staff who hold essential local knowledge of DNO networks which is so vital to the rapid restoration of lost supplies during times of exceptional events. Past OFGEM policies have contributed overwhelmingly to the loss to DNOs of this resource.
9. Prospect are totally opposed to the alternative proposal contained in paragraph 4.3, that there could be ex-post performance assessment judged by technical consultants. We do not think it is constructive to employ consultants to "double guess" DNOs operational decisions. Companies should be free to make their management decisions on a day to day basis at the relative time with the test of their policies judged on the basis of average performance.

Distributed Generation

10. We have in previous submissions expressed our support for OFGEM's approach to Distributed Generation including the Intervention Funding Initiative (IFI). We recognise that Government policies in privatising of the electricity supply industry was characterised by a falling support for Research and Development (R&D). We welcome OFGEM's support for greater inter-company collaboration to redress the decline in investment in R&D projects. We believe that such investment will lead to greater benefits to consumers, national prosperity and in all probability export opportunities for the companies involved. We have no particular preference for any one of the several alternatives suggested to encourage efficient use of IFI funding. We do believe, however, that the results should be publicly available.

Assessing Costs

11. We welcome OFGEM's demonstration of commitment to transparency by publicising consults reports etc. We have little sympathy with those companies who also apparently cherish these principles except when it means publicising information about their own individual performances. We do not believe that hiding behind a cloak of "commercial confidentiality" serves the interest of any interested party. We would encourage OFGEM to continue to press for greater openness and transparency by all stakeholders.

Organisational Changes

12. Whilst we recognise the move to service companies that has occurred it remains our view that there have been unquantified costs incurred by DNOs as a result of the loss of skilled competent staff. Their functions have been transferred to less committed

and arguably less competent employees of service companies leading to higher operational costs in training, supervision and less reliable standards of workmanship masked by inferior employment packages of the service companies.

CEPA-S Benchmarking Report

13. We agree with the DNOs preference for the use of average benchmarking measures.

14. Prospect would certainly be opposed to the inclusion of international comparative data at this time. European or North American DNOs may be similar types of companies but they are frequently operating in inherently different physical conditions and different legal bases. Further, some of the companies analysed are non regulated capital intensive industries. We are suspicious of some of the analysis that has been undertaken. By constructing an averaging process across different types of analysis CEPA has attempted to construct apparently well founded targets for TFP and PFP growth for DNOs. However, historical TFP trends for individual DNOs themselves (let alone in comparison with completely different industries) are highly variable with average growths over an eleven year period ranging from 0.5% and 7%. We wish to reserve our judgement that TFP and PFP analysis of the type used by the CEPA can be safely imported into the debate on DNO efficiency especially when the estimates derive partly from such unscientific sources as analysts' predictions. The case for imposing further arbitrary productivity improvements as a result of these studies or even the "frontier" DNO has not in our view been proven.

Treatment Of Pension Costs

Methodology Statement

15. There would appear to be some areas for misunderstanding in this section of the document. In the past, within the context of the current consultation process, OFGEM

stated that they would not be benchmarking employment costs on this occasion. This paper contains several references. For example Paragraph 7.67 - :

“.....costs will continue to be benchmarked....pension costs will not be benchmarked separately.”

16. Clarification of precisely what is intended, what will be benchmarked and how the benchmarking will be achieved and published would be welcomed.

The same paragraph also says that OFGEM is:

“developing a framework of rules that can be applied in all cases”.

17. There must be an absolute assurance here that assumptions used by actuaries, who are themselves the technical advisors to the various pension schemes and funds are consistent, otherwise it would seem that the rules may not apply fairly. Furthermore, it is not at all clear whether the reference in Paragraph 7.68 refers to the “..... most recent, full actuarial valuation” ie; the triennial valuation required by rule or the rolling valuation that all groups of the Electricity Supply Pension Scheme (ESPS) are undertaking. There must be a constant measure and common reference point. Clarification of intent is imperative.

18. Similarly, whilst the measures might be “..... based on reasonable assumptions.....” it is highly unlikely that financial and demographic actuarial assumptions applied to each group of the ESPS are or will have been uniform. There will almost certainly be differences between the groups of the ESPS. Differences of qualification and entitlement exist between groups closed to new entrants, comprising deferred and pensioner members only; to groups with deferred, pensioner and contributing members.

19. It is understood that some actuaries are saying that the “.....average remaining service life of the active membership” is the very longest period that they would be prepared to accept. In this paragraph OFGEM are suggesting that a deficit will be recovered over periods no shorter than the “..... average remaining service life of the active membership of the scheme”. There appears to be a difference here. Clarification would be appreciated because the costs could be significant.
20. Within the setting of the methodology statement OFGEM should explain what will happen if a principal employer became insolvent with a deficit due to the limitation on the payment period imposed by an OFGEM decision. There is a requirement to clarify who would be responsible for all the costs falling on the scheme or fund as a result of an enforced departure from the advice of the independent actuary determined in accordance with appropriate professional practice. Recognition needs to be given to the consequence that the chain of liability could rest with an insolvent employer resulting in costly litigation in Courts both within and/or outside of the UK.
21. A clearer definition of the term “log up” in paragraph 7.6 is required. It has no real mathematical meaning.
22. Prospect generally supports the OFGEM’s preferred option identified in paragraph 7.71.
23. Prospect would welcome clarification to how OFGEM will analyse the evidence to be provided of the underlying costs incurred by contractors to the monopoly network businesses. Will the employment cost variables be benchmarked? How will the pension costs incurred by the operation of a defined benefit scheme be compared against those offered by a defined contribution scheme, or in the circumstances where the contractor offers no pension provision to his employees whatsoever?

24. Prospect is in general agreement with the principles discussed in paragraph 7.73.

However, we would welcome clarity as to whether this paragraph is intended to refer only to the early retirement deficiency costs as originally calculated or to future sums arising from the subsequent performance outcome of the investment strategy supporting the pension liabilities. Furthermore, whether companies will be penalised in circumstances where the investment performance delivers returns below expectations.

Allocation Between Price Controlled and Non Price Controlled Activities

25. In general terms Prospect believes that the complexity of the division of liabilities and assets described in these paragraphs are too theoretical. They fail to appreciate the complexity of scheme administration that is likely to arise. There is no indication that the independent role of trustees and their professional advisers are to be respected. We do not believe that there can be the imposition of an arbitrary decision by OFGEM on a strategy adopted by a trustee group whose primary duty of care is to members of the pension fund, not employers or electricity consumers.

26. Several DNO pension funds have pension liabilities for pensioners or deferred pensioners of unregulated businesses. Such companies will have no opportunity to recover pension costs from these areas under the proposals. This is a further example of the unacceptability of the OFGEM proposals.

Over or Under Provision

27. Prospect believes that a difficulty with the arrangements discussed in this section relate to the recent historical experience of the majority of electricity industry pension schemes. Every one of the final salary pension schemes enjoyed a healthy surplus

during the past decade. Many employers took a contribution holiday or reduced their level of funding below that demanded by the rules. Each action was approved by the Trustees on advice from their actuary. Some companies closed their final salary schemes to new entrants. Others offered alternative greatly inferior defined benefit schemes. Decisions appear to have been based upon accounting practices, employment package choices or simply the overall dividend policy of the company.

28. These decisions were taken on the basis of prevailing conditions. In the circumstances we think that the most equitable method would be the first bullet point in paragraph 7.81. The selection of this option would mean that the reference period discussed in paragraph 7.82 would be largely a matter of choice. On this basis we believe that the over or under provision mentioned in paragraph 7.83 should be calculated on the basis of information derived from all electricity industry pension funds or schemes (not exclusively DNOs funds) rather than a comparison with some external measure. We believe that this information could be easily produced by the actuarial practice who are the appointed actuaries to the overwhelming majority of the electricity industry's pension funds. We believe that the information will provide a reasonable basis for building into future price control mechanisms, an allowance for pension costs which would have the virtue of being directly relevant to the collective and individual network monopoly companies actual experiences.

Early Retirement Deficiency Costs

29. Prospect agrees with the proposal that adjustments should be made to exclude the impact of early retirement deficiency costs where these were funded from surpluses. The degree of retrospection is a matter of choice but we would only comment that we believe that whatever period is selected the actual reference date should be a consistent base measure. We believe that there should be a common date consistent with all other aspects of the proposals discussed in paragraphs 7.64 onwards.

Stewardship

30. Prospect agrees with the principle of the application discussed in this paragraph and particularly the nature of DNO comparisons. We believe that the comparative criteria reinforces our view that all comparisons related to the treatment of pension costs should be based on a measure of the experiences of the companies affected by the price control and not other external comparators.