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Dear Nienke Hendriks

ELECTRICITY DISTRIBUTION PRICE CONTROL REVIEW: POLICY DOCUMENT

I am writing, on behalf of Prospect, in response to the Electricity Price Control Review Policy Document issued in March.

Having had the welcome opportunity of a useful wide-ranging discussion about the Policy Document with David Gray and Cemil Altin, at this stage we wish to focus on the issues of pensions provision, the price control formula, and cost implications arising from the current employment and skills profile. However, we would also wish to put on record our appreciation of the more open and flexible approach being taken by Ofgem than in previous Distribution Price Control Reviews (DPCR), both in opening up the process of consultation to workforce representatives and in the substance of the proposals. For example, we welcome the approach to encouraging investment in innovation and the recognition of the need for action to ensure a skilled and qualified workforce going forward, though we would like to see a more explicit statement to this effect in the final proposals.

Pensions

Uncertainty about the treatment of pension costs is a significant risk to Distribution Network Operators' (DNOs) business and this uncertainty is contributing to arguments for an increase in the cost of capital. In addition uncertainty about future pension rights is a significant deterrent to long-term recruitment of new professional staff into DNOs and an obstacle to the movement of staff around the industry. Under the Electricity Act 1990, all DNOs have a duty to retain a final salary pensions scheme offering at least equivalent benefits as the Electricity Supply Pensions Scheme in operation at the time but the entitlements from the scheme are restricted to staff in post before 1990.

From our broad experience of representing professional, specialist and managerial staff across a range of economic sectors, Prospect believes that the provision of such a final salary pension scheme is a reasonable market expectation for employees of DNOs. Whilst many of the service support companies within the sector do not offer such a pension scheme, this is due to a combination of economic uncertainty driven by short-term contracts with DNOs and the widespread opportunistic use of redundant DNO staff already in receipt of a final salary pension. The costs of such commercial exploitation are ultimately passed on to the consumer.

Prospect agrees with the proposal in Section 7 of the Policy Document that companies should be given an allowance to meet the cost of final salary pensions in each five year review. This pensions allowance should be calculated for each DNO by reference to the actual pensions costs incurred in providing pensions to all staff allocated to the regulated business. Each DPCR should recalculate the expected allowance required by each company in the next review period and calculate the costs incurred over the price control period so an adjustment may be made for over and under funding of pensions costs. In this way, as recognised in Sections 7.41-43 of the Policy document, considerable uncertainty may be removed by reassuring DNOs that pensions costs for regulated activities can be met through the price control thus removing one pressure to increase the cost of capital. At the same time, this mechanism would ensure that customers are only meeting the true cost of pensions provision incurred by each company and remove any perverse incentive to reduce the level of pensions provision.

Prospect recognises that Ofgem will provide further information in June on the allocation of assets to determine the split of pensions deficit between staff in the regulated business and those allocated to non-regulated business. Whilst Ofgem is minded not to set a standard actuarial process for the determination of pensions costs, we regret the decision not to support the use of an independent actuary. We do believe that the DNOs should be required to explain why the actuarial assumptions used to determine pensions allowances are reasonable.

With the exception of Early Retirement Deficiency Costs (ERDC), Prospect recognises that there is insufficient evidence to determine whether or not DNOs under or over funded their pensions schemes in previous price control periods. Given this lack of clarity, we believe that no under or over funding adjustment is appropriate for prices up to April 2005. On the assumption that pensions were adequately funded in that period, then future price adjustments should cover all pensions costs for staff employed in regulated activities.

Consumers have benefited from previous redundancy programmes through reduced operating costs that have led to Ofgem setting lower charges for distribution. Since much of the costs of redundancy was funded through surpluses facilitating the early payment of pensions, consumers have benefited from the deferral of early retirement deficiency costs as the full funding of deficiency costs at the time of redundancy is likely to have generated higher operating costs and a more lenient price control review in 1995 and 2000. Indeed if pensions schemes had continued to generate surpluses, the benefit of those surpluses would have been shared with consumers through the lower operating costs as ERDC would not have been incurred directly.

Due to the lack of separation of operating costs by Ofgem in previous reviews, there was no debate about the transfer of these costs to consumers if the financial position of the pension schemes changed in future. Therefore the absence of that debate should not be regarded as indicating that there was a consensus that the DNOs would meet their costs without any impact on charges to consumers. Perversely such uncertainty has led some DNOs to reduce the level of pensions benefits offered to entrants since 1990, thus passing some of the costs of retirement to taxpayers and the remainder to staff. We do not believe that it was the intention of Ofgem to create an incentive to reduce pensions benefits below market rates and do not believe that it is appropriate for Ofgem to shape remuneration by reducing the value of pensions.

In these circumstances, we believe that the cost of ERDC should be passed onto consumers when these costs cease to be absorbed by pension surpluses. In this way the consumers continues to receive the benefit of lower operating costs through funding redundancy from pensions scheme surpluses and only picks up the cost of early payment of pensions when such charges are incurred by the DNOs. Given the current position of pension schemes, we believe that some element of ERDC has already been borne by the DNOs and that the 2005/10 price control should be adjusted to reflect the cost to each DNO.

Price Control Formula

The Policy Document invites comments on whether the CPI should replace the RPI for price control purposes. Though Prospect would not rule out such a change at a later stage in appropriate circumstances, we would not currently support the use of the CPI.

The all-items RPI remains the most commonly used yardstick for pay bargaining purposes, and is likely to remain so for some time. A recent survey by independent pay analysts Industrial Relations Services found that 76% of employers said that the RPI was likely to influence their next pay settlement and that the headline rate of inflation was the most commonly monitored measure. Even the Government's own pay remit guidance for the Civil Service does not suggest that the CPI should be used in pay negotiations.

Also, where price indices are used to help determine the costs of procurement and contracted services such as staff, we understand this generally continues to be based on the RPI. Similarly, other employment-related calculations, including the indexation of tax allowances, are done on the basis of the RPI. This also applies to indexation of the state pension and other benefits.

CPI and RPI measures of inflation have diverged in recent years, despite the generally low inflationary climate, and are likely to continue to do so. According to IRS, the gap ranged between 0.7 and 1.7 percentage points during 2002/03 and averaged 1.2%. In such circumstances, a decision to base the price control mechanism on CPI is likely to be seen as a mechanism for lowering expectations. It could consequently also open up a wider debate about other components of the "RPI-x" formula. However continued use of RPI does not prevent continued use of supplementary cost data or decisions informed by alternative price indices, as appropriate.

Whilst it is entirely appropriate for the Bank of England to seek to influence the parameters of economic and financial decision-making in this way, OFGEM should not see itself as a prime mover in this context. It should seek to work with the DNOs in the interest of customers; yet forcing the pace of change on this issue is more likely to cause additional complexity for no clear benefit. Any reassessment of the position should occur at the next DPCR.

Employment-related costs

Clearly the cost of capital is key to the DPCR. The need to set a realistic cost of capital is emphasised by the significant investment programme required to maintain and improve the quality of supply. Section 7 of the Policy Document sets out a range for the cost of capital that reflects a variety of factors. Prospect believes that the decline in the technical skills base and the emphasis on relying on up-skilling of staff rather than full professional training has reduced operating costs and led to lower short-term prices for consumers.

However this process has reduced promotion opportunities, has inhibited flexibility of movement and the development of professional skills and reduced the attractiveness of a career in the sector for professional engineers and other key professional staff. In addition, the significant redundancy programmes designed to reduce headcount have reduced the number of highly skilled engineers in the sector and eroded the base of skilled project managers. Prospect recognises that resolving these skills shortages is a matter for the union to resolve with employers, and we are doing so through a variety of mechanisms.

However, whilst we do not expect Ofgem to interfere in the operational management of companies, Ofgem establishes the financial framework for future operations in the absence of competition. For Ofgem to meet its target of maintaining and improving system resilience, there is a need to increase the range of skills available to DNOs and to develop the application of those skills. We believe that this process carries some inherent risk and given the cost structure of the DNOs we believe that this has an influence on the cost of capital. Therefore Prospect would expect Ofgem to use the higher end of the range of the cost of capital so long as there was a need to strengthen and develop the professional and technical skills of staff. Given the long time required to train and develop staff who carry out key professional roles and the need to encourage their retention, we believe that these risks will apply throughout the 2005/10 price control period.

Having considered the cost projections provided by the DNOs, Prospect agrees with some of the DNOs that the shortage of key professional skills is likely to see significant increase in employment costs as there is a need to develop skills to even maintain current operational capacity. Whilst we do not have access to the detailed analysis that led to an assessment that operating costs can fall, it is clear to us that underspend has arisen as a result of programmed work not being carried out due to a lack of appropriately skilled staff. It is not realistic to assume continued reduction in staff costs given the wish to increase capital investment and the level of demand for professional and technical staff.

There is not a pool of surplus professional engineers available to contractors or DNOs and we believe that even though our constructive relationship with all DNOs will enable further improvements in efficiency these will moderate any increase in staff costs rather than enable DNOs to reduce them. Quite simply, all the easy productivity improvements have been achieved and some of the legacy of low operating costs has been the deferral of the training and development costs needed to run a sustainable distribution sector. We also believe that the projections of reduced staff costs were based on the assumption that Ofgem would place a predominant priority on restricting capital expenditure to reduce charges to consumers rather than following a more balanced approach to meet the twin aspirations of consumers for reasonable prices and a high quality of supply. It is therefore is appropriate and timely to move away from a regime of detailed benchmarking of employment costs, and we are pleased that Ofgem appears to have recognised this. Any benchmarking of costs should be at a more strategic level and based on advice that is open and transparent. Under no circumstances should such advice take precedence over the normal processes of negotiation with recognised trade unions.

We trust that these views are of interest and hope to see them reflected in the Interim Proposals to be published in June.

Yours sincerely

Sue Ferns
Head of Research and Specialist Services