Electricity Distribution Price Control Review

Initial Proposals

Prospect Response

Submission by Prospect to OFGEM

6 August 2004

1. INTRODUCTION

1.1 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 member's direct operational and technical knowledge and experience to perform our assessment.

2. PRELIMINARY REMARKS

2.1 Prospect recognises the commitment by OFGEM to offer incentives for investment and efficiency but we harbour genuine concerns that the proposals contain inadequate funds to enable DNO's to invest in the greatly needed and widely acknowledged recruitment of additional numbers of professional and specialist staff throughout the industry. The incentives offered should be sufficient to enable all DNOs to recruit additional staff where further technical expertise is crucial to improved quality; similarly the penalties for non-delivery should exceed the costs of recruiting extra staff to avoid creating a false incentive to reduce standards of service.

2.2 Without greater investment in staff we do not believe further efficiencies sought by the outcome of this review could still be achievable. This situation has already been recognised by a number of authoritative sources such as:

- Research undertaken by the former Electricity Training Association (now part of the Energy and Utility Sector Skills Council) who identified skill shortage levels throughout the industry.

- Your own network resilience working group who identified the need for resources particularly to be available to respond to major storms and the potential risk of shortages of skilled staff in the future.
- House of Commons Trade and Industry Committee inquiry into the resilience of the National Electricity Network suggested that even if there was no significant problem with skill shortages at present (and views differed on that) that it was clear that the electricity industry was not attracting enough engineering graduates.

2.3 There appears to be an informed acceptance that a skill shortage exists. Prospect recognises that there are some positive steps being undertaken in an attempt to overcome the difficulties. However our view remains that OFGEM had failed to provide adequate allowances for the early recruitment and training of staff, to address these needs but has also failed to acknowledge that expenditure will be required by DNO's to improve the skills of existing staff as they replace those who reach normal retirement age or leave as a result of natural wastage.

2.4 These considerations do not appear to have been fully considered and consequently are not reflected in the setting of the operating cost allowances for the price control period.

2.5 The broad philosophical thrust of these DPR proposals continue to be almost a total reliance on market mechanisms to the exclusion of practical aspects of delivering electricity to the nation. Prospect have commented previously that future reliance on the RPI minus x formula resulting in staffing cuts, followed by yet more staffing cuts is unsustainable.

2.6 We would welcome the opportunity to discuss alternative formula with you well in advance of the next price control review.

2.7 Although Prospect generally believes the approach of OFGEM is sound and recognises the improvement in process, the current results are disappointing, because:

- The cuts in Opex make the reliable management of the distribution system more difficult without an increase in numbers of employees engaged on permanent employment contracts, who are the key to the efficient maintenance and reliability of the DNO networks. We explained to you that we did not believe the formula will permit DNO's to recruit the necessary skilled staff or in some cases retain them in a competitive market place. We do not think you appear to have taken into account costs that arise from implementation of incremental salary scales and the need for additional renumeration for those staff who improve their skill base or competency-based pay schemes' after incremental scales as our argument is that skilled staff need adequate pay rather than an argument that incremental pay systems are expensive.

- The proposed rise in capex is welcome. However, we remain unconvinced that it is sufficient to deal with the replacement of ageing assets whose life expectancy has already been extended beyond their original design years.

- We have always supported the extension of embedded renewable generation but are disappointed that the financial returns are likely to fail to provide an adequate incentive for DNO's to exploit the technical opportunities for additional system security that is potentially on offer.

3. PRICE CONTROL

Revenue Driver

3.1 You will recall that we expressed some reservations regarding the decision – paragraph 3.6 – of the proposal to eliminate any volume driver attached to EHV services at the next price control period. We took note of your explanation that this decision had been taken at the request of DNO's who apparently did not believe there would be any significant commercial exploitation opportunities in the future.

4. REVENUE PROTECTION

4.1 We conveyed our view that consistent with other principles of this review it should be a responsibility of the individual DNO's to ensure that revenue losses are minimised. We think that this could realistically be achieved through the incentivisation of supply companies.

4.2 Ultimately it is the consumer who bears a significant proportion of the costs associated with revenue losses. For this reason we believe the issue should be addressed as part of the next price control period when greater emphasis can be placed upon DNO's to minimise losses. In the meantime, OFGEM could give a clear incentive to companies by announcing that revenue protection measures introduced during the course of the next five years will achieve the payment of retrospective rewards. We would expect successful outcomes to be measured against known criteria.

4.3 We will respond to your invitation to put forward ideas to achieve the desired aims of reducing distribution electrical losses.

5. DEALING WITH UNCERTAINTY

5.1 Prospect recognises that the Electricity Safety Quality Continuity Regulations (ESQCR) address significant aspects of safety. Consequently we are disappointed that OFGEM has failed to address many of the operational issues, which stem directly from the implementation of these regulations as part of this price control review. We were comforted to learn that it is your intention to revisit the resource implications as soon as the anticipated revision of the existing ESQCR regulations had been completed along with an appropriate revision of DNO licence conditions. Further, that the review will be conducted on a stand alone basis without either expenditure or savings being offset against other individual company programmes.

6. OVERALL INCENTIVE RATE

6.1 We share the view expressed that there should be a significant increase in the existing incentives to attack the problem of system transmission losses. However, we would question whether the suggested mid point figure is adequate to encourage DNO's to seriously address the problems, particularly bearing in mind the Government's ambition to reduce the level of losses. This is an area where DNO's can commit resources by offering technical solutions to long standing problems in the knowledge that expenditure would be recovered within a fairly short time span. For these reasons we would suggest an upper quartile figure of around £51/MWh would be more appropriate.

7. METERING

7.1 Our view on metering remains. We support the concept of establishing a separate metering price control mechanism outside the present distribution price control considerations.

8. QUALITY OF SERVICE

8.1 Prospect welcomes confirmation of OFGEM's policy of improving the incentive regime but we remain of the view that the proposed incentives are insufficient to encourage the urgent need for greater investment in resources to carry out the work to be undertaken by DNO's. Whilst quality performance and other related information may have become more reliable, there is no indication to show that the nature of the geographical territory within which the companies operate or the planning consent considerations they face have been taken into account. It is our belief that these tend to differ from region to region and authority to authority. The overriding absent determinant factor continues to be the availability of skilled and technically competent staff who have the essential knowledge of DNO's networks. This local knowledge is absolutely vital to rapid restoration of lost supplies during interruptions.

8.2 We are concerned that the incentives scheme may encourage greater contractorisation to meet short term needs during times such as a loss of supplies, as well as in the continuing need to ensure the robustness of the network in terms of the planned maintenance activity. We believe that a cadre of permanently employed and appropriately skilled staff would be the best insurance to secure improved performance in these areas.

8.3 You explained to us that the incentives had been established against a rigorous set of benchmarks related to system similarities within DNO's which should not result in the greater use of contractor staff.

8.4 We remain greatly concerned that the capital expenditure allowances will be insufficient to meet the needs for additional training of the staff required to meet the benchmark performance levels. You acknowledged that views had differed between ourselves and the DNO's on this aspect. You also suggested that it could be helpful if we provided some evidence to indicate how DNO's were meeting the resource implications of their CML's and CI's profile.

8.5 We note that some companies are already outperforming their incentive targets for the current year. You confirmed to us that the rewards proposed for WPD were in respect of speedy restoration times achieved during normal performance and that future achievements of this scale by companies would be rewarded at the next Price Control Review. A scheme to encourage the better performance identified in Tables 4.3 and 4.4 is an area where we understand that DNO's will be making further representations to yourselves.

8.6 Prospect welcomed the clarification contained within the proposals that top performers would be rewarded.

9. STORM ARRANGEMENTS

9.1 We are pleased to note that DNO's will be provided with an annual cost allowance to meet exception events, although we do not believe the purchase of storm insurance cover is a realistic alternative.

9.2 The recently published House of Commons Trade and Industry Committee report. "The resilience of the Electricity Network" comments on the recommendations of the Network Resilience Working Group (NRWG).

> "……………identify the need for resources to be available to respond to major storms and the potential risk of shortages of skilled staff in the future"

9.3 The report also remarked –

> "……………… however we were not given the impression that either the government or the regulator is fully appraised of the particularly difficulties faced by the electricity industry. If engineering is regarding as unattractive by potential undergraduates, power engineering is even less attractive. We expect the government as a matter of priority to take appropriate measures to guarantee that this country has the skills required to ensure the resilience of the electricity infrastructure"

9.4 The NRWG report also highlights several major skills - related issues affecting current trends and the future security of a robust electricity distribution network maintained by a competent workforce.

9.5 We do not believe that the shortcomings, which have been – yet again - independently identified by a wide range of experts will be resolved until DNO's are given the flexibility within their investment programmes to recruit and retain appropriately skilled staff. The delivery of improved customer services without greater investment in staff resources to meet the daily and sometimes uncertain challenges faced by network operators will be jeopardised. We were encouraged to learn from you that some companies were to bring vegetation control activities 'in house' in the future.

10. DISCRETIONARY REWARDS

10.1 We note the OFGEM proposal to appoint a multi disciplinary panel to assist in the development of a discretionary reward criteria scheme. It is our view that the trade union voice should be heard in this forum. We welcomed your acknowledgement that the trade union voice would provide an objective input based upon a sound knowledge of the categories set out in the paper. We will provide a nominee of Prospect to you in this regard.

11. DISTRIBUTED GENERATION

11.1 We welcome clarification of the thinking behind the 90% pass through of the IFI arrangements. It can be reasonably anticipated that consumers will benefit from the implementation of IFI projects throughout the life of the project and beyond. In these circumstances it would seem unreasonable to introduce a cost recovery cap – albeit a diminishing level throughout the duration of the projected five year life span of each project. We are doubtful whether there will be an adequate incentive for companies to co-operate in these areas unless there is a greater encouragement to invest in new technologies, which will eventually extend to large numbers of the nations consumers. We think the proposal would benefit from being re-visited.

11.2 We are aware that a recent House of Lords Science and Technology Committee inquiry into the 'Practicalities of Developing Renewable Energy' recommended that OFGEM prioritise the provision of incentives to remove technical barriers to distributed generation. The report reflects our view that technical solutions will not be developed by companies unless the rewards for investment in R&D are perceived worthwhile in commercial terms. Without an adequate reward structure the Government's policy of encouraging further development in renewable energy could well be jeopardised.

11.3 We noted your assertion that OFGEM will review progress towards the greater expansion of distributed generation during the course of 2007.

12. COST ASSESSMENT

12.1 We are pleased to observe that OFGEM recognise the existence of variable regional factors. Salary and wage costs are and continue to be a significant aspect of costs to companies serving South East England. It is unclear however whether this factor has been identified in the calculation of the Competent Scale Variable (CSV) the restriction of additional pay costs to London Power Networks is unrealistic given the wider economic pressures within the South East as a whole and we would expect any assessment of costs to recognise that higher pay rates apply throughout Greater London.

12.2 We believe that the companies are correct in advocating support for the use of average benchmark figures in the measurement of performance and efficiency.

12.3 We are disappointed that there has been no recognition of the increased activity associated with the control of vegetation in the form of tree cutting costs. It has been recognised that the containment of vegetation growth through sound management has the simple expedient of saving operational expenditure at times when companies are faced with abnormal weather conditions. Tree cutting costs were an easy method of reducing operational expenditure to meet the policies laid down by OFGEM in past reviews. For these reasons we think that there should have been some allowance given to companies to overcome the amount of work associated with the clearing of the backlog in tree cutting beyond the cost allowances for exceptional (future) events. We took note of your statement that allowances for this activity had been met in the previous price control period but there was some evidence to show that the money had not been spent by the companies.

12.4 Elsewhere in the proposals (paragraph 6.13) there is a recognition that repair and restoration under full conditions are substantial categories of costs. Yet there is a reluctance to provide DNO's with operational or capital expenditure allowances to meet tree cutting costs essential to the maintenance of reliable electricity supplies to users. Targeted expenditure on such measures can make a vital contribution to the maintenance of supplies at all times and not simply during abnormal weather conditions.

13. PENSIONS GENERAL

13.1 Prospect reaffirms it's support for the principle of passing through to consumers pension costs incurred by DNO's and notes that an update of pensions costs will be published in September.

13.2 Prospect welcomed the statement contained in the proposals – paragraph 7.29 – that the allowed pension deficits would be spread over thirteen years and would provide the annual amount of funding for those deficits.

13.3 Recognising that the costs set out in Table 7.2 are provisional, we will welcome confirmation that the deficiencies identified in this table relate to only those in each group of the Electricity Supply Pension Scheme (ESPS). We welcomed your assurance that you will insist that the final figure supplied by DNO's must be supported by a full actuarial certificate; that the figures are an accurate extract from the accounts of the relevant group of the ESPS; together with a statement that the figures have been agreed with the Trustees of each Group of the ESPS. You accepted that funding assumptions of each Group of the ESPS would differ because there would be some variables or inconsistencies with deficits arising from the adoption of a different set of assumptions, although each decision would have been adopted on the basis of facts derived from a uniform date. This should be acceptable recognising the legal responsibilities of Group Trustees are to their specific group. We believe it important to acknowledge their decisions had been taken on the basis of professional actuarial guidance.

13.4 We request you to satisfy yourselves that DNO's are not seeking compensation for deficits attributable to liabilities in respect of employees who were formerly employed in other parts of the unregulated business and who are not strictly a cost on the distribution activity. Prospect would wish to be assured on the basis of an actuarial statement, that the actual cost (s) incurred in providing pensions to all staff allocated to the regulated – distribution - parts of the business have been taken into account.

13.5 You confirmed to us that the companies had confirmed to you that there were no deficiencies within any of the alternative (to ESPS) occupational pension packages on offer within DNO's. In the earlier consultation document issued in March 2004 reference was made – paragraph 7.23 – to a;

…………….‵broad framework for the treatment of pension costs and therefore also apply to National Grid Transco (NGT) and the Scottish Transmission businesses'.

13.6 The latest paper refers to the Scottish companies but reference to NGT has been omitted. You confirmed to us that the position within NGT and the Scottish Transmission Business' would be addressed as part of the transmission price control review.

13.7 Prospect consider it would be helpful if OFGEM were to include a statement clarifying this situation in the next consultation document.

14. ERDC'S

14.1 Prospect are supportive of the proposals contained in paragraph 7.33. We recognise that in some companies shareholders as well as consumers shared these benefits. It seems to us that this a reasonable and fair proposition.

14.2 We firmly disagree with the contention that;

"…….it was inefficient for companies to make contributions to the scheme that were not needed at the time".

14.3 This is questionable. Had companies not taken contribution holidays it is quite possible that the current level of deficit funding may have been lower. Investment returns in the years immediately following the decision to reduce contribution rates and therefore income, into the various groups of the ESPS may well have been higher. With the benefit of hindsight it could be argued that consumers are now being asked to pay for the questionable DNO management decisions of the past.

14.4 We remain of the view that any adjustment should be made to exclude the impact of early retirement deficiency costs where these were funded from the use of surpluses.

14.5 We are of the view, however, that any attempt to adjust the figures by assessing the impact of a theoretical investment returns had ERDC's been paid at the appropriate time would require a significant time consuming examination of a wide-range of statistical information. Any interpretation of such information might well be regarded as a presumption. Prospect would point out that investment decisions would have been taken by Group Trustees on the advice of investment managers and in accordance with the individual investment strategies of each group of the ESPS. Decisions would have been taken on the basis of the size of investment capital available at the time for investment. In the event that the ERDC's had been made available at the time it is quite possible that alternative investment decisions may have been adopted.

14.6 In these circumstances and recognising that in accordance with the strict application of OFGEM principles a deduction may be appropriate, we believe it would be reasonable to ignore this aspect as part of the current price control considerations.

14.7 You acknowledged there was some merit in our view that it would be entirely reasonable to give a clear statement of future intent.

14.8 If this issue remains current then assumptions may have to be made in the future on the basis of a clearly understood measurement mechanism. Faced with a clear statement of future policy objectives companies would be free to determine their financial decisions on the basis of alternatives.