Transmission Price Review:

Second Consultation Document

Submission by Prospect to Ofgem

JANUARY 2006

INTRODUCTION

1. Prospect is a trade union representing 105,000 scientific, technical, and managerial staff in addition to other specialist professions across the private and public sectors, including major utilities and the Civil Service. In the energy sector, we represent engineers, managers and other professional specialist staff in the electricity supply industry and, increasingly, also in the gas industry. Within the three transmission licence holders, National Grid, ScottishPower and Scottish and Southern Energy, our members are responsible for operational and technical management, and the provision of professional engineering and other technical services. Other members work in a range of sectors and functions where the regulation and operation of electricity and gas transmission companies are of significant professional concern. We are fortunate in being able to draw on this broad range of knowledge and expertise to inform our views.

2. Our response concentrates on the issues raised in the second consultation document published by Ofgem in December 2005. Given the importance of the price review to a variety of Prospect members, we intend to play a full part in the remainder of the consultation process

3. Aside from the importance of increasing efficiency, the price review should consider the following three factors that require additional capital investment and possibly higher operational expenditure:

   - The decline of UKCS (United Kingdom Continental Shelf) gas production and the development of new import terminals;
   - Shifts in the generation mix with a focus on renewables; and
   - Increased environmental concerns.

DOCUMENT FOCUS

4. Ofgem focuses its efforts on the development of appropriate incentives for investment in an efficient transmission network. During the last review period, in general, Transco's system was highly flexible in responding to demands for new capacity not foreseen at the price review but are criticised for being too complex. By contrast the National Grid Company incentives were clear but so inflexible that Ofgem agreed to individual price controls for specific renewable projects that may have undermined the general price incentives. The use of properly designed incentives can benefit the consumer by placing a significant financial reward for meeting quality; this process usually requires the input of professional and technical staff and the overall structure of the price control should balance the incentives with general cost reduction so the transmission licence holders are not penalised for making reasonable investment in staff and equipment to achieve the objectives that carry financial incentives.

5. We believe that the system of incentives should encourage a long-term perspective for capital investment that extends beyond the next price control period as the phasing of both capital projects and the development of skilled technical staff requires a longer planning horizon than the next five years. Moreover we see a potential detriment for the consumers if major capital projects are simply deferred to the next review period since this raises the risk of artificially creating a peak in capital spending that is likely to be less efficient than smoothing the investment profile over two or more review periods. This approach requires both adequate funding for capital investment from 2007 to 2012 along with effective incentives that reward efficient management and planning of both capital and operational expenditure without creating a perverse incentive for simply deferring spending which raises the risk of reduced long-term reliability in the transmission system.

6. With respect to the development of renewable generation, there is a need to ensure that the full costs of meeting this goal of Government policy are considered by the transmission price review.

7. Three factors drive this process:

- The differences in location of renewable sources of energy compared to existing generation sites;

- The highly variable availability of renewable generation that has both capital impacts in the need to accommodate substantial amounts of conventional generation in reserve and the additional operating costs generated by the need to undertake work as the system operator to balance renewable and non-renewable generation in real time; and

- The relatively small size of renewable generation projects that restricts their ability to contribute to system reinforcement forcing the costs to be smeared across consumers as a whole if significant increases in renewable generation are to be secured.

8. The aims of Government energy policy are demanding and Prospect believes that significant investment in the electricity transmission network is required before 2012 if the 20% renewable target for 2020 is to be achieved. Moves to increase the use of wind, wave and tidal generation will lead to a significant reorientation of the Great Britain transmission network to accommodate these additional sources of generation. Many of the best sites for renewable generation are remote from areas of high electricity demand and require significant investment if the electricity is to be efficiently transmitted from generation sites to customers. Moreover the current operational workforce of National Grid is sited efficiently for the current network configuration and additional costs will be required to transfer, train and locate staff in the new sites of increased transmission activity. Incentives to increase operational efficiency should consider these location factors, as there has been a tendency to centralise National Grid's gas and electricity activity in the Midlands to reduce costs when the future points to greater activity in Scotland, Wales and the North of England.

9. The consultation document appears to assume a high level of distributed generation embedded in distribution networks; however this was not reflected in the assumptions for operating costs built into the Distribution Price Control Review (DPCR4). Given the requirement on transmission asset owners and National Gird as the system operator to accommodate increased renewable generation, we believe that an automatic adjustment should be made to transmission income if a higher proportion of renewable generation is connected to the transmission network rather than being embedded in distribution networks above the level assumed in this document.

10. Renewable generation is highly variable with very low levels of plant availability: wind generation is extremely sensitive to variations in wind speed that are difficult to predict ahead. Therefore the development of substantial renewable generation will require the maintenance of considerable conventional generation reserves; this has a twin impact in National Grid with the requirement of investment in significant amounts of additional infrastructure to accommodate new sources of supply and the requirement to manage flows of electricity with current levels of accuracy despite significantly greater variation in the availability of plant. The problems of diverse locations creating stranded assets and the need for incentives to create penalties for additional investment to meet new sources of supply whilst retaining penalties for inappropriate investment in stranded assets is also likely to occur in gas with the development of LNG import terminals at Milford Haven and the Isle of Grain to supplement the main sources of UKCS gas at Bacton and St Fergus.

11. Traditionally large generation assets have been able to absorb significant Grid reinforcement costs as their activity creates the need for system reinforcement through connection charges. Due to the much smaller scale of renewable projects, the funding of reinforcement costs through connection charges will become uneconomic and will deter small-scale renewable projects connecting to the National Grid unless such charges are smeared across all consumers.

INCENTIVES

12. Prospect supports the use of incentives that drive quality measures that are designed to benefit the public interest and whose benefits outweigh the additional cost of requiring greater professional staff input than traditional cost reduction. We believe that given the pressures of significant change to the transmission network to accommodate new forms of electricity generation and new import terminals for LNG that this more sophisticated approach is more likely to benefit the consumer than the traditional focus on cost reduction incentives.

13. The document focuses on the options for incentives and financial issues affecting the transmission business, including pensions. The pensions issue is key as both ScottishPower (SP) and National Grid (NG) have indicated that the financial and regulatory constraints imposed on final salary schemes create significant pressure to close the final salary pension schemes to new entrants. Given the uncertainty attached to defined contributions schemes, employees are likely to seek significant improvements elsewhere in their remuneration to balance the higher risks thus increasing costs to the electricity and gas consumer by failing to recognise the different financial position of regulated utilities.

BENCHMARKING

14. In appendix 10, Ofgem refers to the benchmarking of total operating costs. Whilst we recognise the desire to manage employment costs efficiently and the importance of creating incentives for companies to employ sufficient skilled staff to operate these capital-intensive businesses efficiently, Prospect is concerned about the use of benchmarking to measure efficiency as it fails to account for differences in productivity between operators and the benchmark groups are typically drawn too wide to provide meaningful comparators for salary costs. In the last Transmission Price Review, Ofgem referred to benchmarking data assessed by its then advisers, Arthur Andersen that looked at general salary levels within the industrial sector, relying in part on Hay job evaluation. In our experience, private sector employers rarely, if ever, negotiate or offer salaries to professional and other highly skilled staff based on such a general assessment of a broad range of staff. Remuneration comparisons are more productive when focused on the specific skills required by a business and are at best guides that need to be considered along with several other factors, including organisational culture. Benchmarking should not be used as a substitute for the operation of the employment market.

15. In the electricity networks sector, there is a dynamic employment market and salaries are set by collective bargaining constrained by both the incentives on the Company to efficiently mange the business on behalf of their shareholders and the arguments made by trade unions on behalf of their members. There is no evidence to support the suggestion that National Grid salaries are out of line with the market. It would be inappropriate to ignore the key economic signals generated by influences, such as the current skills shortage, by imposing an unrealistic benchmark based on a basket of other large companies. By artificially depressing salaries below their appropriate market level, Ofgem would inhibit recruitment: thus rendering National Grid unable to retain key managerial, professional and technical staff thus reducing the efficiency of the business, transferring risk to the consumer. The same arguments also apply to the two Scottish transmission asset owners who also operate distribution companies.

16. Whilst there is a less well-developed market for gas transmission skills, with the sale of the gas distribution networks such a market will develop unless employers act in unison to restrict salary growth. Even if Ofgem believes that some benchmarking is necessary to assess the competitive cost basis of gas transmission, it needs to be conducted carefully and to place due weight on the salary levels achieved by the operation of the market in electricity transmission. Many National Grid staff already operate in both electricity and gas operations: this process is likely to continue where integration of operations shows a benefit in efficiency.

PENSIONS

17. Ofgem's approach to pensions is a derivation of the standards set in the Distribution Price Control review (DPCR4). The twin pressures of both substantial pensions deficits and more stringent regulation is leading all three transmission companies to reduce the value of pensions for new starters. As an opening point, it is the interests of all stakeholders to argue for a pensions regime that reflects the specific nature of the transmission business with long-term financial stability and the limited expectations of growth in the UK regulated business, despite the need for substantial capital investment over the next 10 years. This reduced risk of financial default in pensions can justify less onerous financial controls on pensions costs compared to private sector employers operating in a fully competive environment with the benefits to the consumer of lower corporate financial risk and hence a lower cost of capital. The alterative path of discouraging final salary pensions schemes simply threatens to increase operating costs through higher remuneration to cover the increased risk to employees: this would also increase costs to consumers. It would be perverse for Ofgem not to seek a pensions regime for regulated utilities that could reflect the different nature of financial exposure of these organisations if it reduced unnecessary financial risk and hence cost to the consumer.

18. Ofgem presents five areas of inquiry for this consultation exercise as follows:

- Pensions charges for gas distribution networks (GDN) as four of these networks have been sold and the remaining four are outside the scope of the Transmission Price Review;
- The valuation and funding of pensions schemes under the new regulations;
- The allocation between regulated and non-regulated activities;
- The treatment of under/over funding; and
- The treatment of early retirement deficiency costs.

19. **Gas Networks:** To reduce uncertainty that increases the cost of capital and disadvantages consumers we seek a consistent approach to the treatment of gas distribution and gas transmission pensions issues similar to the treatment of electricity transmission and distribution pensions. This approach needs to recognise that since 2002 NG has made many people redundant from the distribution networks business who worked on assets that have been transferred to other GDN owners. The pensions deficits for these former staff still remains with National Grid.

20. **The valuation and funding of pensions schemes:** There is a contradiction between the guidance given by Ofgem and the rules set by the pensions regulator that increase the cost of pensions to the companies and hence to the customer. The regulated monopoly nature of the transmission business and the duties placed on Ofgem to ensure financial stability give transmission operators a lower level of risk than most private sector companies and the reasonable prospect of addressing pension deficiencies in a longer timeframe. For this reason, we believe that it is appropriate to a return to the longer time scales for addressing pensions deficits for the regulated business. Funding pensions fund deficits over 15 years is appropriate for transmission operators as the risk of default by a transmission operator is significantly lower than an average employer and even if the business became insolvent, the underlying monopoly asset is almost certain to continue to operate. However we believe that this variation should only apply to those companies who employ the staff allocated to the transmission business and that any transfer of staff to separate infrastructure operators should automatically lead to the full transfer of sufficient funds to meet pension liabilities.

21. **The allocation of costs between regulated and non-regulated activities:** Whilst avoiding cross-subsidy of the competitive business seems sensible, three factors need to taken into account:

- The extent to which the competitive business reduces the level of business support costs for the regulated business through economies of scale;

- The degree to which staff move between regulated and non-regulated parts of companies with a transmission licence. Such moves are taken to improve efficiency by sharing resources across a corporate structure, as in cases where Human Resources services are provided centrally to the entire corporate group and to improve individual effectiveness by personal development. So long as these processes do not generate uncompetitive behaviour, the consumer benefits from these efficiency improvements so it would be perverse to penalise licence holders and their employees by rigorously restricting the recovery of pensions costs to staff currently employed in the regulated business; and

- The changes within the business and in the scope of regulation that means that some of the pensions deficits for individuals now employed in the non-regulated business were accrued during their service in a regulated activity.

22. **The treatment of under/over funding:** Given the unique nature of the transmission business and the constraints on the use of pensions surpluses created by the Electricity Act 1990, there is a strong case for allowing a more permissive approach to the elimination of pension deficits and the retention of any future surpluses within the scheme.

23. **The treatment of early retirement deficiency costs (ERDC):** Customers have already benefited and continue to benefit from the early retirement programmes that have been run by National Grid, Transco, Scottish Power and SSE through the lower cost base of all transmission operators. Given that these costs represent compensation to staff for the loss of employment, it is appropriate for the full cost of ERDC to be recovered through charges to consumers where they contribute to a pensions deficit.

TRAINING

24. Although the consultation document does not refer to training, the transmission sector is subject to the same skills shortages as the rest of the electricity networks sector. With the substantial increase in capital expenditure by Distribution Network Operators (DNOs) to meet customer expectations about reliability, demand for technical and engineering skills is high. The structure of the contract market has relied on competitive tender for short-term contracts with little guarantee of long-term contracts. The sector-specific skills, used by engineers and technicians, require sustained and extensive training with an average apprentice requiring three to four years' training and engineers requiring at least two years post-graduate or post-apprenticeship training.

25. Therefore the contract structure does not encourage investment in skills training by contractors leaving responsibility for the bulk of training and development to network operators. The short-term desire to reduce contract costs has inhibited significant training initiatives by contractors to the familiarisation training required by network operators so individuals become authorised to operate on any particular operator's network.

24. Due to the close alignment of DNO and Transmission operators' skill requirements, effectively they effectively seek contract staff from the same pool and aim to recruit very similar groups of staff. Lack of regulatory support for training initiatives poses a serious risk to consumers as the industry is short of the key skills required to implement a dramatic increase in capital expenditure. The significant costs of training should be considered as part of the operating costs of the businesses and prospect believe that a separate training allowance for all network operators would be the most effective instrument for ensuring that sufficient skilled staff are trained to meet consumer expectations. Allowing each operator to spend their allowance on a company-specific training scheme would create the variation in training that would avoid the gaps created by national schemes in the past.

CAPITAL ALLOWANCE OVERSPEND

25. NG has significantly overspent its capital allowances to improve system resilience and to accommodate significant tranches of new renewable generation. Whilst some of the renewable costs have been recovered, the bulk of capital expenditure overspend has not. Since this expenditure has been incurred in meeting customer expectations of quality and a wish for higher environmental standards, then it should be recovered from customers over the five-year regulatory review cycle.

CONCLUSION

26. Prospect welcomes the opportunity to discuss the impact of regulation upon transmission licence holders. The current regulatory review is one of the most significant influences upon the future of our members employed in these businesses. We are concerned that the review process should set an effective framework for the development of these businesses without unnecessarily intrusive regulation, which inhibits developments that benefit consumers whilst setting unrealistic and unreasonable constraints upon the negotiation of salaries and other conditions of employment. In particular, we believe that it is not in the consumers' interests to inhibit the recruitment and development of the professional staff whose expertise is required to maintain existing performance and to develop new initiatives that promote improved levels of customer service and cost reduction.

Prospect
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