Transmission Price Control Review

Submission by Prospect to Ofgem's Initial proposals

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INTRODUCTION

1. Prospect is a trade union that represents over 100,000 professional, managerial, technical and scientific staff across the private and public sectors. In the utilities sector, Prospect represents engineers, managers and other professional across the electricity supply industry and increasingly within the gars and water sectors.

2. As with the 2004 Distribution Price Control Review (DPCR4), Prospect has responded to the various consultation papers issued by Ofgem as part of the current Transmission Price Control Review (TPCR) process, highlighting our concerns about the impact on consumers and employees of change. 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.

3. With the consistent policy direction set out in the ongoing Energy Review, we believe that TPCR should set a sustainable framework that enables transmission operators to respond efficiently to consumer demand. In addition to efficient pricing, consumers expect to be protected from additional financial risk due to the deferment of investment or maintenance as well as being protected from the risk of unreliable supplies. Whilst all three transmission licence holders have very high levels of reliability, the response to power cuts in 2004 showed that consumers' reliance on efficient electricity supplies has increased since privatisation in 1991 and current levels of transmission reliability should be maintained with a gradual increase in reliability over the life of the price control. We see no argument to suggest that consumer dependence on reliable gas supplies is any lower and we believe that gas reliability should also be maintained with the objective of an incremental increase over the life of the price review as new capital investment occurs.

4. We still believe that the three main drivers of the development of both gas and electricity transmission networks are:

    - 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 with potential new nuclear build; and

    - Increased environmental concerns.

5. In the initial proposals' paper dated 26th June, Prospect has identified the six following issues for comment:

   - The treatment of staff costs;
   - Pensions and early retirement deficiency costs;
   - Assumed efficiency gains:
   - Capex adjustments;
   - Incentive schemes; and
   - Reopening of the review.

6. We recognise that the treatment of staff costs and incentives will be considered in more detail in the updated proposals anticipated in September. At this stage, we shall explain how our initial views set out in our response of January 2006 have developed in response to the consultation process.

Staff Costs

7. In January 2006, we expressed our concerns about the potential for unsophisticated benchmarking of staff costs when National Grid operates in a mature and competitive labour market for its entire staff, with the potential exception of some gas skills where a market has yet to develop. At that stage, we were confident that there was no evidence to support the claim that National Grid's salaries were out of line with the actual market for professional, managerial, technical, and administrative and craft skills relevant to national grid's regulated business. We also expressed our concern about the impact of regulation on training as we believe that an over-stringent approach to staff costs that restricts training is against the long-term interests of the consumers as it is likely to lead to higher salary costs and lower service standards in the medium and long-term. Over the past six months, we believe that the utilities employment market has shifted to reinforce our views as there has been buoyant salary growth in response to skills shortages and growing demand for those skills, both from network operators and from contractors.

8. As a matter of principle, we believe that salary scales should be 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. We do not believe that it is the role of Ofgem to set salaries across the transmission sector and we have no wish for Ofgem to acquire that responsibility: it is equally clear that Ofgem has no desire to pick up the role of former national negotiating bodies and negotiate salaries across the transmission sector. That is a clear duty for the three transmission operators and the five recognised unions.

9. Therefore any assessment of salary costs that feeds into operating costs allowances or capital expenditure allowances should be based

on a realistic assessment of likely salary growth. However the initial proposals document assumes that there will zero real wage growth during five years when :

- Labour skills are expected to remain limited due to long training requirements and a shortfall in training over the past 15 years;
- substantial increases in capital expenditure during DPCR4 up to 2010 will fuel a significant surge in demand for professional, technical and craft skills within the utilities sector when other sectors that use those skills are likely to experience similar skills shortages;
- average salary growth in the economy as a whole is expected to continue to exceed inflation as measured by RPI by an average of 1% p.a.; and
- already some long-term pay deals within the electricity supply sector demonstrate strong earnings growth over the next two years.

10. We believe that the figure of zero real wage growth is simply unrealistic and would prevent constructive salary negotiations over the life of the price review. Even to achieve salary stability, the initial proposals are calculated on the assumption that there is continued productivity growth of 1½%, apparently after some reorganisation of National Grid's managerial and maintenance processes. In our experience, achieving such productivity growth without any real increase in salaries is extremely difficult and increases the regulatory risk of transmission businesses by appearing to place a regulatory barrier against the payment of efficient salaries to drive technological innovation and productivity growth.

11. We consider it important that any study of salary costs should consider relative productivity. Ofgem's duty is to protect the consumers' interests by setting a financial structure that encourages efficient and effective operation of the transmission businesses. This should take a realistic view of future salary costs that allows the businesses and the unions to develop salary structures that fit the specific circumstances of each transmission licence holder.

12. The provision of adequate training is undoubtedly in the long-term interests of the consumer as the reliability and efficient operation of the system is reliant upon the technical and professional engineering skills of staff. Whilst Ofgem believes that the provision of an explicit training allowance to encourage the further development of a national training scheme for utilities sector would be a too intrusive form of regulation, there is still a need to ensure that regulation does not inhibit training.

13. Over the past fifteen years, the provision of training by network operators has reduced; at the same time the pressure to reduce shirt-term costs has worked against the development of long-term contracts that encourage contractors to train their own craft, technical and professional staff for the electricity supply industry. Whilst the industry and the unions are developing schemes to address these issues, there is a need for adequate finance of training and a need for Ofgem to recognise that training of large numbers of professional and technical staff is a costly activity. For this reason, we would expect to see the cost allowances for all transmission operators to allow additional staff costs to provide for the renewal and development of skills in the utilities sector.

Pensions and Early Retirement Deficiency Costs

14. Whilst Ofgem states that it is the intention to apply the same criteria as in DPCR4 to pensions costs, there appear to be a very different approach to the treatment of Early Retirement Deficiency Costs. The use of early retirement since privatisation has been a mechanism for reducing the costs of change, allowing the transmission licence holders to accelerate the process of change and reduce the lump-sum redundancy benefits by including early payment of pensions as part of the package. Whilst there has been an obvious advantage to redundant staff and to the licence holder as operating costs are reduced since the licence holder is incentivised to reduce costs during the life of a price review by retaining additional profit, the consumer has benefited from the reduced operating cost base and the benefits of early retirement up to 2001 have been passed to the consumer in the form of lower prices.

15. We believe that transmission licence holders should be able to recover ERDCs on the same basis that Ofgem has made an allowance for the other deficiency costs run up by the various pensions schemes operated by the transmission licence holders that relate to the regulated transmission activities of those companies. This would allow the overwhelming bulk of ERDCs to be recovered through transmission charges.

16. We also believe that the treatment of pensions needs to be consistent over a longer period than the life of a single price review. Given the long-term monopoly nature of the transmission businesses, there is a strong case for a pensions regime that provides a stable commitment to final salary pensions schemes. Already, our evidence suggests that the benefit of final salary pensions schemes is reflected in salary levels with most contractors paying a significant premium to professional engineers to compensate for the lack of a final salary pension scheme.

17. The alternative 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 unique nature of financial exposure of these organisations if it reduced unnecessary financial risk and hence cost to the consumer. We note that Ofgem is seeking a lower rate of return for the transmission businesses and it seems perverse to create uncertainty about pensions costs if this is the objective as financial risk will drive up the costs of capital.

Assumed efficiency gains

18. As noted in paragraph 10, Ofgem has assumed that productivity will increase annually by 1½% in addition to any productivity gains stimulated by the various system operator incentive schemes under consideration. In our experience, such productivity gains are the result of hard work and experimentation by both the licence holders and staff rather than an automatic consequence of owning a transmission licence. Therefore we are confused by the assumption that this will occur when Ofgem expects the licence holders to effectively freeze salary costs in real terms for the life of the price control. We note that these improvements are on top of measures to address deficiencies that Ofgem believe are a result of existing sub-optimal efficiency in the provision of support services and maintenance regimes as set out on paragraph 3.22 of the consultation paper.

19. We believe that any move to increase productivity by 1½% requires a more realistic approach to salary and training costs over the life of the price control as explained above. We would like the opportunity to discuss the suggested productivity gains that precede the 1½% productivity gains as these may have a significant impact on our members; we believe that it is inequitable for Ofgem to impose price reductions on the basis of consultants reports without consulting or informing Prospect as a representative of affected staff.

Capex Adjustments

20. We recognise the benefits of a sliding scale approach to capital expenditure when much of the proposed capital investment is uncertain due to the pace of new generation projects, especially renewable schemes distant from main centres of electricity consumption. However we are unclear whether or not the base capital allowances for all three transmission operators takes into account the costs of assessing applications for connections and other planning activities that are required even when these reinforcement and extension schemes do not take place.

21. There is significant opposition to passing the full costs of preliminary planning to generators as this is seen as retarding the growth of renewable and CHP (Combined Heat and Power) generation. Thus some of the planning and other non-recoverable development costs for unsuccessful or undelivered schemes borne by the transmission licence holders should be recoverable through the adjustment process where the principle of shallow charging does not allow the transmission licence holder to recover these from the potential generator.

22. With regard to question 7.1, Prospect agrees that the differences in business structures between the three licence holders are so significant that a consistent approach to the definition of capex and quasi-capex is not possible.

23. We note that the transmission activities of SPTL and SHTL are highly integrated with the distribution activities of both parent companies: ScottishPower and Scottish and Southern Energy. In these circumstances, it is difficult to justify a lower cost of capital for the transmission activities of these companies as they are now less risky than the equally monopolistic distribution businesses run by both groups. We agree with Ofgem that the Scottish businesses are now no more risky than National Grid's two transmission licences so a consistent rate of return should be applied to all four TO licences. Therefore Prospect does not regard that a lower rate of return for transmission compared to Distribution is justified and we would like to return to this issue once Ofgem has reconsidered its position for the updated proposals paper in September.

Incentive Schemes

24. Whilst in principle, Prospect recognises the value of incentive schemes, there is a need to discuss this process in more detail. We are particularly concerned that a crude incentive to reduce spend below the capital allowance is not in the consumers' interests given the major pressures for change on both electricity and gas transmission networks. Similarly we are not convinced that in a period of significant change that the focus should be on ensuring that medium and long-term projections of consumer demands are met as this could distort investment by creating a signal that meeting budget is more important that actually meeting those consumer demand. Therefore we are inclined to explore the viability of using the more detailed analysis suggested in paragraph 7.34 to provide the basis of an incentive scheme but we would wish to review the actual proposals in the updated proposals paper due in September.

25. We also note that for National Grid any TO (transmission owner) incentives need to consider in conjunction with the SO (system operator) incentives. Therefore we believe that further work is required to consider the full incentive package as a whole and that this issue should be considered in form depth in the September update of proposals.

Reopening of the price review

26. Given the importance of reducing regulatory risk, we are generally opposed to any reopening of the price review mechanism between 2007 and 2012. Both licence holders and staff require some degree of certainty to implement change efficiently and the five year price control does give this certainty.

27. However in the circumstances of the Government's energy review, there may well be a significant change in the mechanisms used to deliver public policy. At present, there is occasionally a misconception that some of the public duties of the former Department of Energy have passed to Ofgem or the transmission holders, such as a duty to secure an appropriate margin of generating capacity above peak demand, when this is not the case.

28. It is conceivable that the Department of Trade and Industry will either acquire further duties that impact on both Ofgem and the transmission licence holders or widen the scope of Ofgem's statutory responsibilities in manner that impacts on licence holders. It is equally possible that Government opts for no change at all and relies on a fine-tuning of existing powers to achieve its policy goals: so it is unwise to introduce speculation about the outcome of the Energy Review into the price control, yet.

29. Once the Energy review has reached its final conclusion, then we would welcome consultation on the impact of those changes on Ofgem and the transmission licences: incidentally we would wish to see the same process applied to electricity and gas distribution licences.

Conclusion

30. Prospect welcomes this further opportunity to comment on the impact of Ofgem's proposals for transmission regulation. We remain convinced that the future development of the transmission networks to meet consumer needs and to develop Government energy policy require a degree of certainty for staff. The professionalism and expertise of our members is crucial to the success of the transmission licence holders and we believe that Ofgem should not obstruct the continued application of engineering and other professional expertise to find practical solutions to the challenges facing the transmission businesses up to 2012. Therefore we are disappointed at the apparent urge to restrict salary growth and reduce the funding of training over the next price review. Whilst this is clearly not in our interest, we also do not see how it is the consumers' interests to discourage the maintenance and development of greater professional expertise during a period of rapid growth in the transmission networks.

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