DPCR5

Prospect submission to Ofgem consultation: Electricity Distribution Price Control Review Policy Paper Ref: 159/08

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INTRODUCTION

1. Prospect is a trade union that represents 102,000 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 gas and water sectors.

ENVIRONMENTAL ISSUES

Innovation and future networks

2. Prospect has previously taken a particular interest in the potential reconfiguration of the distribution network to accept more Distributed Generation (DG). We therefore have read with interest the narrative from paragraph 2.52 in relation to the experience with incentives to create Registered Power Zones (RPZs).

3. We have previously commented upon Distributed Generation in our submission to the DTI in January 2007, when we summarised our view by saying that Government should set a consistent framework for network control but should not micro-manage it. The best way for the Government to encourage Distributed Generation is to remove barriers to entry and innovation by providing appropriate incentives to DNOs to manage DG effectively and then allowing the market to develop and identify the appropriate sources of this form of generation.

4. We note that in paragraph 2.61 the conclusion is that incentives available to date have proved to be insufficient to overcome what is described as the "business as usual" approach of the DNOs. In our view, it is not just a degree of inertia which influences the slow uptake of new forms of DG but rather genuine technical challenges, as well as insufficient incentives to give momentum to this aspect of energy policy.

5. We have previously commented (Prospect 2007 submission) that we were not persuaded that DG would lead to improvements in network flexibility, not least because of the significant additional investment needed in distribution networks to make this happen. We said that although existing networks are capable of taking new power flows there are key physical differences between networks below 132kV that are designed as passive systems and those at higher voltage levels that can be actively controlled. There are protection related challenges to address in order to manage the interaction of DG with the high voltage network. If increasing amounts of Distributed Generation are added, local systems will increasingly need to be redesigned around it. These features will be expensive to install, lead to more complexity and add to the challenges of network management. Most importantly, they will also require different skill sets efficiently to deliver.

6. That said we believe our views in relation to the encouragement of Distributed Generation remain relevant to this DPCR5 Consultation. In that respect we have previously said that DG should be promoted as one of the primary sources of energy efficiency improvements, perhaps by linking it to an explicit requirement towards energy efficiency in electricity supply licenses. This would have to be set in the context of the drive for low carbon investments and incentives. Consideration

obviously needs to be given to minimising the costs associated with small-scale electricity generation and the challenge of potentially aggregating micro generation to facilitate that output reaching the market.

7. Given the split between distribution and generation activities and the need for DNOs to allow lower voltage generators to connect directly to their networks, it is important to modify the conservative approach to investment that anticipates demand for increases in network capacity. With a need for a significant increase in the amount of renewable generation attached to networks, it will be critical to assure DNOs that they are not going to be penalised for producing stranded assets when generators' plans change and demand for capacity in a particular location decreases. This will continue to throw up tensions between the desirability of stimulating Distributed Generation connections and a requirement on Ofgem to ensure efficient pricing. Therefore, as we have said before, we favour a shallow pricing policy that will (a) ensure DNOs can recover the costs of connecting schemes that they would otherwise not choose to connect due to the additional commercial risk placed on them and (b) not unreasonably penalise DNOs when generation demand changes after plans to strengthen the distribution network have been implemented.

CUSTOMERS

Customer preferences

8. Ofgem's own customer research has shown that customers place most value on reducing the carbon footprint of DNOs and improving restoration times during faults.

9. The reduction in carbon footprint requires better incentives to reduce distribution losses as proposed in the consultation document that attach a value to technical losses that creates sufficient incentive to invest in equipment upgrading and replacement to reduce losses.

10. In terms of customer interruptions and improved response times, there is value in improving the data collected by DNOs. But there is a point at which the value of collecting data outweighs both the cost to consumers of collecting this data and the diversion of resources from repairs and restoration to data collection. There have been significant improvements in the quality of data collected over recent years. There now needs to be an assessment of the value of further incentives to improve data quality, as customer preference is for the swift restoration of their supplies rather than the provision of improved data on the duration of interruptions.

11. Ultimately the improvement in customer supply relies on improved engineering performance both by the deployment of more skilled staff and by improving the technical performance of network equipment. The incentives for improved performance should remain clear and should secure an appropriate balance between the speed and quality of communication with customers and the speed with which supplies are restored.

Customer connections

12. Whilst we recognise the potential cost impact of inadequate competition in connections, Ofgem should recognise that DNOs may chose to specialise in particular areas of the connections market. This is so they may make best use of their staff and commercial expertise as they reduce overall market share.

13. One of the main barriers to connections competition remains the lack of suitably skilled technical and engineering staff. This is particularly important for HV and EHV connections. Too harsh an approach to introducing competition in these more complex market segments risks reducing the attraction of a career as a connections engineer. This is because it raises doubts about the sustainability of employment in this field when compared to other parts of the DNO; and a reduction in profit margins will impact on the funding available to train HV and EHV connections engineers. Therefore any test of competition needs to be sophisticated and recognise that different DNOs have clearly taken very different strategic approaches to providing a range of connections services.

Defining the worst served customer

14. The experience of Prospect members suggests that the length of interruptions remains a significant factor for worst served customers. Therefore the definition of worst served customers should consider both the frequency of interruptions and their total duration.

15. There is concern that sufficient depot locations exist to provide a high standard of service across the entire franchise area. This has the added benefit of reducing the carbon footprint of DNOs. Whilst the location of depots should be a DNO commercial judgment based on the best mechanism for ensuring they improve service to consumers, we believe that removing the length of the interruption from the definition of worst served customer may reduce the incentive to consider the best mechanism of providing a satisfactory level of service across the entire franchise area. We welcome the introduction of an incentive to improve performance for worst served customers, but this should not be at the expense of other customers who remain intolerant of any increase in the frequency or duration of faults.

NETWORKS

DNO behaviours

16. We appreciate that the list of desirable behaviours includes managing the safety of employees, investing in a sustainable workforce and encouraging the growth of distributed generation. Our concern is that the pricing regime has failed to encourage this behaviour in the past and we would wish to see steps taken to ensure that there are more stringent incentives to promote these behaviours.

Meeting the Skills Challenge

17. Given the increasing complexity of networks with a shift from passive networks to active networks as DG expands and the need to apply complex engineering judgements to ensure the efficient repair, maintenance and replacement of equipment, we believe that there is need to increase the level of engineering expertise available to the sector at a reasonable cost to customers.

18. Prospect is particularly concerned that this price review ensures adequate resource allocation to meet the costs of bridging the skills gap which has opened up in the Electricity Supply Industry (ESI) generally and notably within the DNOs.

19. We note that in paragraph 4.42, Ofgem is reviewing the work of the Energy and Utility Sector Skills Council (EUS) and the ENA, which suggests that an additional £158.5m of expenditure (across Opex and Capex) is required in the DPCR 5 period. This involves recruiting and training an additional 9,000 staff both direct and contract labour. In our view this is a critical element of the price review and must correctly be achieved if we are to avoid energy policy objectives, of which network renewal is a crucial component, being hampered. We support the analysis of EUS and have been able to participate directly in its development at various junctures. The evidence from our relationships with the companies in the industry is of a tightening of the labour market for engineering, technical and craft skills. This is despite the economic downturn of the last 12 months as many of the skills required are specific to the sector and the training required is lengthy. Whilst reduced economic activity will have an impact on aggregate demand, the process of network renewal is a longer-term process beyond the immediate challenges of the economic cycle. Moreover, the DNOs, as with the rest of the ESI, are the potential source of high quality jobs critical to stimulating the economy and fulfilling Government policy.

20. We are already seeing evidence that financial pressures on the ESI companies are leading to job losses. Although these are currently in activities beyond the scope of the DNO businesses, particularly in ‘retail’, the pressures on financial markets are, in our opinion, also having an impact on the readiness of companies to deliver projects that are in any way discretionary. Whilst companies must deliver those projects which are consistent with meeting their license obligations, any discretionary spend which may augment networks and therefore require the requisite skills to be deployed, are going to be under sharp consideration as the cost of capital increases. Even ESI companies, that would in the past have been gilt-edged investment propositions, are encountering appreciating capital costs as investors and lenders become more risk-averse.

21. Therefore, in our view, Ofgem needs to look to the medium and long term for this industry by ensuring a substantial allocation of revenue in the price review so that the companies can meet the skills gap. Quite simply, if this is not the outcome, there will be real restrictions upon the ability of companies to deliver the networks required to meet energy policy objectives. In the medium to long term, investment in skills reduces the cost to customers of operating an efficient, responsive, low-carbon electricity distribution network by reducing the long-term cost of

engineering skills and by extending the life of assets. The substantial cost of premature asset replacement is thus avoided.

Equalising incentives: capex v opex

22. Prospect believes that DNO managerial decisions have been distorted by the perception that Ofgem is more likely to reward capital investment over operational expenditure. The combined challenges of efficient operation, meeting raised customer expectations and addressing the environmental targets set by Government, require a different response from different DNOs due to differences in combinations of technology, network structure and staff complements. Determining the best approach to securing best value from existing assets requires proficient engineering assessment. For instance, whether to extend their life, improve their efficiency or move to earlier asset replacement. Such judgement should not be distorted by judgements over whether Ofgem will treat capital investment more leniently than operational expenditure.

23. In these circumstances we believe that a shift to equalising the incentives for capex and opex as set out in option 2 in paragraph 4.60 would benefit both customers and DNOs. It would equalise incentives for capital and operational expenditure, thus allowing judgments to be made on the basis of engineering knowledge and the specific financial circumstances of the business at that time. For example, the phasing of asset replacement to avoid significant peaks and troughs of activity is likely to reduce the overall cost of asset replacement in each network.

Cost uncertainty

24. Whilst we recognise the benefits of giving DNOs added protection against the cost of sudden fluctuations in input prices, similar to variations in the cost of copper and steel during DPCR4, we believe that these protections should meet the following three criteria:

- the protection should be limited and should increase risk by imposing overzealous symmetrical allowance reductions when prices fall. There is some value in DNOs prudently hedging themselves against input price variation by signing long-term contracts for some services and materials and a rigid indexation system for costs could deter such prudent behaviour;

- the costs that are subject to variable allowances should be those where the DNOs ability to control these costs is limited; and

- the indexation of costs relies on a reliable cost index and these are more rare than is sometimes thought to be the case.

25. Prospect does not believe that tying employment costs to a rigid index would be helpful, as it would restrict commercial decisions over the deployment of staff and the development of skills. Apart from our scepticism that an effective index of labour costs exists, we do not believe that it is appropriate to undermine collective bargaining to improve pay and corporate efficiency by setting an external benchmark on salary levels.

Health and safety

26. Given the recent deterioration in safety performance across the ESI, Prospect is concerned that incentives set by Ofgem overlook the creation of disincentives to invest in better health and safety performance. Any training allowance should include health and safety training; and incentives on customer performance should contain some element that relates to the health and safety performance of the DNO.

27. Ofgem was established to protect gas and electricity consumers by promoting competition and regulating the monopoly companies which run the gas and electricity networks. It regulates the revenue earned by the Distribution Network Operators (DNOs) through the application of incentive regulation. This involves setting each DNO a base revenue allowance sufficient to cover efficient investment and operating costs while delivering required outputs.

28. The Health and Safety Executive (HSE) was set up to protect people against risks to health or safety arising out of work activities – this includes customers and workers. HSE regulates goal-setting health & safety law, applying a range of approaches including encouragement (such as promoting business benefits) and the appropriate use of enforcement powers.

29. The Utilities Act 2000 acknowledges the link to workplace health and safety of Ofgem's activities by providing consultation duties designed to promote regulatory consistency in customer and worker protection. A Memorandum of Understanding between Ofgem and HSE provides a working framework for a coherent approach [http://www.hse.gov.uk/aboutus/framework/f-mou_j.pdf], which has regard to the health and safety of both "members of the public" and "persons employed in connection with" the generation, transmission, distribution or supply of electricity.

30. Prospect believes there is an evident link between safety in the industry and the demands of the regulatory regime. Whilst a DNO may contest what it concludes is an unacceptable outcome to a price review through the MMC, it is highly unlikely that would happen purely from concerns about work pressures resulting from the review. Our understanding, arising from discussions with Ofgem, is that they regard workplace safety as essentially beyond the scope of their regulatory responsibilities, because it is implicit that DNO submissions take account of all their statutory responsibilities, including those related to safety. Moreover Ofgem may rely on the perception that a DNO would not agree to regulatory proposals if they believed compromised safe management of the system. That is credible in theory, but in reality the work tempo arising from operational demands conditioned by the regulatory regime is far more difficult to predict when considering the acceptability of price proposals.

31. Prospect members in DNOs have understandably been shaken by the fatal incidents in recent years. They are concerned about the consequences of work intensification over recent price reviews and fear that this cannot be sustained without undermining efficiency, health, well being and safety. Therefore in our view Ofgem should enquire further about the likely impact on operational demands of proposals within DPCR5 and it is legitimate to factor into these considerations how

DNOs can deliver their health and safety responsibilities. This analysis should reconsider the assumption that an agreed price review equates to the means having been provided for all DNO obligations to be discharged.

FINANCIAL ISSUES

Cost of capital and current economic climate

32. The energy industry needs significant investment to achieve many of the Government's targets (renewables, energy efficiency, nuclear etc.). We have already stated our belief that investment in the energy industry would be timely considering current economic condition. The current climate for raising finance for investment is very tough. Available capital is limited and the price of capital is higher (particularly for utilities) meaning returns have to be attractive enough to attract the capital that is available. Current regulated returns in the UK are not high enough to cover cost of raising capital or high enough to attract limited capital available for investment. Regulatory authorities in other countries are responding to these conditions and UK has to react to keep pace

33. Whilst interest rates have dropped significantly over the past six months, we are concerned that the lower base-rate cost of borrowing could distort decisions over the appropriate rate of return. As base rates have fallen, lenders and investors have become substantially more risk-averse, augmenting the cost of capital in sectors that are seen as being risky.

34. In addition, ownership of the DNOs has become increasingly international in recent years, with Scottish and Southern Energy remaining the sole UK-based owner. Owners will therefore compare the reward and risk balance for DNOs within a global context. Whilst targeted incentives do have a benefit in improving performance, we believe that the number and range of financial incentives need to be considered against the increased uncertainty that incentive schemes can generate. If the scope for financial penalty is too large, even if balanced by reward for improved performance, it will create a significant amount of regulatory risk that will push up the cost of capital.

35. Therefore it is important that Ofgem recognises the financial constraints on investment in the UK and the danger of creating extra risk by an over-complex set of incentives. Given the international nature of ownership and current events in the global economy, it would be helpful to consider the electricity network investment policy of energy regulators in France, Germany, Spain and the USA.

Pensions

36. Prospect welcomes Ofgem’s conclusion that there is no need to change the existing pension principles underlying the price review. Ofgem is correct to focus on ensuring the current principles are applied reasonably rather than seeking to change the principles. Given the current financial climate, it is important not to inadvertently create perceptions of additional regulatory risk regarding pensions that could inflate the cost of capital. The current principles generally work well with only efficient pension costs being passed through to consumers.

37. While pension costs may rise significantly over the term of the next review this is in response to factors applying to pension schemes generally and not because excess, inefficient costs are being incurred by regulated businesses and passed through to consumers. Ofgem is well aware of the effect of falling bond yields, increased longevity and increased regulatory burdens on businesses' pension costs. There has been no evidence of businesses either failing to take actions in their power to control pension costs or taking a lax attitude to discussions with trustees over scheme funding arrangements. Where pension schemes have incurred varying contribution rates or have different funding levels this is more likely to be a result of the different features of the relevant schemes rather than evidence that the principles are not working.

38. Prospect believes that independent actuarial scrutiny of regulated businesses' pension costs on behalf of Ofgem is certain to show that pension costs are being managed effectively. The collection of data and work examining any returns will impose burdens on both Ofgem and the regulated businesses. It is very unlikely that these extra costs will result in efficiency savings or reduced prices for consumers so Ofgem's resources would almost certainly be better allocated to other issues under its remit.

39. Ofgem correctly acknowledges that it does not have any power to direct the trustees of pension schemes to make any particular decisions. However any changes to the financial incentives relating to pensions placed on regulated businesses can indirectly influence discussions between scheme sponsors and trustees. Ofgem should recognise the fiduciary duties of pension scheme trustees and not attempt to directly or indirectly influence their decisions regarding these schemes. We believe it would be useful for Ofgem to contact the Pension Regulator before consulting on changes to pricing principles or other regulatory approaches that could have significant implications for the protection of members' benefits. In particular we strongly believe that Ofgem should not raise the issue of buying out members' statutory pension protections nor seek to induce members to give up these protections and we are pleased that no further reference has been made to such issues.

40. A number of application issues are raised in the consultation. Generally these are matters for Ofgem and the regulated businesses and do not directly impact on Prospect members so we will not comment on them in detail. However Prospect remains concerned at Ofgem's attitude towards the treatment of potential scheme surpluses. Pension schemes are very long-term arrangements and it is important not to over-react to short-term, extreme funding positions whether surpluses or deficits. Directions from Ofgem on this issue will cause problems for trustees and could well be counter-productive.

41. Whilst the funding of the Electricity Supply Pension Scheme remains a significant financial issue given the long-term risks being carried by the DNOs, the future pensions arrangements in the distribution sector are likely to be predominantly career average or defined contributions schemes. At present we believe that the costs of such schemes are passed through to the customer and that this should continue in line with the pensions principles established by Ofgem. However this is based upon historic contribution levels and this places a barrier to raising contribution levels to respond to the currently tight labour market for

engineering skills. Prospect believes that the DPCR5 settlement should set a minimum recoverable contribution level for economically-efficient defined contributions schemes that can be passed through to customers to assist investment in a sustainable workforce as set out in Paragraph 4.7 since the present process is an obstacle to recruitment of professional engineers.

PROCESS AND TIMETABLE

42. Prospect believes that the environmental challenge facing DNOs, the need for financial stability at a time of great economic uncertainty and the need to continue to recruit and retain skilled staff are important.

As the body representing professional, managerial and technical staff employed by the DNOs, Prospect clearly has keen interests in DPCR5 as well as significant influence in respect of policy reception. **We would welcome a further opportunity to meet Ofgem to discuss our concerns.**

Prospect
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