

RPI-X@20

Submission by Prospect to Ofgem's consultation document "Regulating energy networks for the future: RPI-X@20 Principles, Process and Issues"
Ref 13/09

April 2009

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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. Prospect therefore has an intimate knowledge and understanding of the issues facing networks and the practical impact of policy upon operations.
2. Prospect welcomes the review of RPI-X as the means by which energy networks have been regulated for the past two decades. The energy networks knowledge of the business impact of incentives has considerably changed since the introduction of this approach to regulation. Networks now have a much broader set of energy policy goals to address, especially in relation to the environment, so a detailed review of the impact of regulation on consumers is timely. Our opinion on the way in which the regulatory framework should develop for the future is influenced by the experience of our members of the practical consequences of the application of RPI-X at a working level.
3. This submission addresses the issues raised in '**Regulating energy networks for the future: RPI-X@20 Principles, Process and Issues**' (ref 13/09) and responds in the order of the consultative document.

Foreword

4. Prospect welcomes this review as we fear the current incentive-based system has placed an excessively high focus on cost control at the expense of other issues of importance to the consumer. This has encouraged short-term price reduction at the expense of medium to long-term investment and innovation that has higher potential consumer benefits.
5. Given the timely desire to consider a wider range of outputs than a simple measure of efficiency by cost reduction, we welcome the goal of greater involvement of consumers in the process. We are interested in how this can be done effectively. Prospect believes that other stakeholders, such as industry unions, should also benefit from enhanced consultation as we can offer relevant experience of the impact of regulation on network performance. Moreover, the response of our members to the incentives placed on staff by regulation is a major determinant of the industry's success.
6. We also welcome the extension of Ofgem's duty to protect the interests of consumers to future consumers and the recognition that in the current energy policy framework, there is a need to encourage more fundamental innovation. However we believe that the success of innovation depends on the industry's ability to develop and retain key engineering and professional staff so that new technical and commercial concepts can be developed and implemented within network operators.
7. If the success of RPI-X were measured by the extent to which crude cost control has become the primary focus of energy network businesses, then it would undoubtedly have met its objectives. The response to every price control review has been cuts in staff, reorganisation and attempts to do more with less. Whilst this may be a rational response to short-term inefficiency and take account of significant changes in productivity arising from new technology or commercial practice, Prospect is concerned. Our view remains that the short-term cost focus of past price reviews has encouraged staff reductions.
8. Only in recent years, as the dearth of technical staff that has affected both regulated businesses and contractors has begun to bite, has the pace of job reductions slowed. If

these companies were ever over-staffed, that is certainly not the case now and alarming skills gaps are emerging. This is but one symptom of the consequences of a regulatory framework that has created a financial incentive for energy businesses to safeguard shareholder returns by seeking short-term cost reductions in staffing and systems. In the long run this create constraints that hamper the achievement of energy policy challenges and undermine consumer interests.

CHAPTER: One - Introduction

9. The regulatory framework must in the future be more adept at ensuring long term investment decisions are promoted, such as those associated with innovation or the training of essential staff.

10. We regard training as a prime example of how the current regulatory system fails to meet the long-term aspirations and interests of consumers in a rapidly changing and uncertain environment. In our assessment, RPI-X has had, perhaps unintentionally, the effect of creating a long interruption in training of over a decade. Only now is there a response, at greater cost and disruption of managerial focus, in recognition of the clear signals that a lack of training has a detrimental impact on consumers.

11. There needs to be much greater cooperation over skills between the energy companies. Initiatives such as the Sector Skills Council developing a Power Sector Skills Academy are welcome, if overdue. The regulatory framework must support this progress but the five-year review periods are too short in that respect and the potential for some companies to avoid training by simply competing for those trained by others must be avoided.

Question 1

12. The current narrow focus of regulation does not help the industry and other stakeholders, such as Prospect, address these concerns in the new environment and therefore the review is highly appropriate.

13. Prospect is concerned that the current regulatory process is overly complex and fails to give sufficiently clear incentives on desirable behaviour. An overly narrow scope of regulation has emerged as far as Ofgem's duties are concerned. For example, in recent years Prospect has raised concerns that increasing work tempo arising from the demands of the RPI-X formula, in particular with respect to customer restoration times, has contributed to a worrying deterioration in safety performance. We do not say this lightly. The statistical data in the SAFELEC reports produced by the Energy Networks Association on behalf of the electricity industry National HESAC highlights the problem. When we have raised this in the context of consultation on the price reviews, we have been met with the proposition that if a regulated business accepts their price review provision, then Ofgem concludes they can meet all of their regulatory and other obligations including ensuring workplace safety. We believe this a failure of the regulatory system and stems from 2 factors: its complexity and the need for routine good housekeeping to consider whether all relevant issues are covered by the price review formula.

14. We believe that Ofgem should have a more explicit requirement to consider and satisfy itself, perhaps in consultation with HSE through risk assessment, that its proposals and the response from the licence holders will not compromise workplace safety. The current framework of regulation is too complex to enable these issues to be

fully debated and the need to clarify incentives so their relationship to safety is unambiguous is an additional reason to review the regulatory system.

15. The Utilities Act 2000 recognises that Ofgem policy affects workplace health and safety in requiring consultation designed to promote regulatory consistency in customer and worker protection. A Memorandum of Understanding¹ between Ofgem and HSE provides the working framework for a coherent approach, 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. In Prospect’s opinion Ofgem should reconsider the assumption that an agreed price review equates to the means having been provided for all DNO obligations to be discharged.

Question 2

16. With respect to wider Energy policy this review is timely, because with companies locked into cost cutting as their primary response to regulatory outcomes, it is difficult to imagine how the switch to an investment phase will be stimulated and sustained. Not only do we need to replace ageing assets across transmission and distribution, but also at a time of recession infrastructure renewal represents a potentially major contributor of high quality jobs. The regulatory framework of the future needs to fit with wider government objectives as described in the new report “New Industry, New Jobs”². Therefore we agree with the broad scope of the review, as we believe that peripheral changes to the current RPI-x paradigm may not meet the extended view of the public interest driven by the larger impact of the environment and the need for more responsive energy networks.

Question 3

17. We accept the themes set out in paragraphs 1.25 to 1.29 of the consultation document. However, we believe they must consider the impact of change upon staff within the networks sector, the incentives that regulation constrains for them and the appropriate mix of commercial freedom and output-driven incentives required to encourage the commercial behaviour most likely to meet consumers needs and environmental goals.

18. Our concern is that without clear policy goals for regulation, much of our infrastructure development will be in response to public policy but delivered by the private sector whose priorities may not coincide with public interest. We believe that consumers will expect a greater degree of government intervention in aspects of the economy that have been given over to markets in the 1980s and 1990s. This is an inevitable reaction to the economic pain that has resulted from deregulation in financial markets. It is no surprise that some commentators suggest the credit crunch will be followed by a power crunch. Therefore the regulatory framework that arises from this review must take account of the new reality. The RPI-X@20 consultation says that one of its key focuses is on consumers. In our opinion, a regulatory framework that ensures private companies meet their obligations to invest, and so provide resilient networks designed to meet new and greener policy objectives, best serves consumers.

19. The evidence of delivery of investment projected in the price review settlement has been mixed as, for example, the Ofgem consultation documents for DPCR5 show. Given that the companies inherited well-maintained and invested networks on privatisation, it was possible to sweat the assets and make strong returns almost in spite of the tightening of the regulatory screw. Those days are gone and whilst Ofgem may challenge

the companies for now seeking revenue for infrastructure that they have received but not spent in earlier periods, the reality is that consumers will suffer if the companies are punished. Therefore the scope of the review must consider how effective light-touch regulation is for energy networks in the current environment. This requires some expert analysis of the industry sectors and the impact of differing incentives upon operators. We believe that Ofgem has occasionally, through a lack of understanding, neglected the impact of industry culture.

Question 4

20. Prospect welcomes this consultation and hopes Ofgem will continue to recognise the value of consultation with Prospect on these fundamental policy issues. Inevitably the process of price control focuses Ofgem on detailed interaction with regulated licence holders: we hope that the new approach will encourage greater interaction with other stakeholders. We would wish to be involved further in working groups as we believe our expertise is constructive and beneficial.

Question 5

21. We have no comments on the timetable other than to reflect on the need to co-ordinate policy reviews and to respond to reviews led by other institutions. For example, we have made a submission to the Energy and Climate Change Select Committee review entitled "The Future of Britain's Electricity Networks". That review covers ground that overlaps RPI-X@20 and we hope that Ofgem will consider this and similar future initiatives to avoid the risk of relevant contributions to the debate having no effect.

CHAPTER: Two - Aims, principles and approach of the review

Question 1

22. We welcome the wider aims of the review so long as they address the impact of regulation upon staff retention, recruitment and development. As stated above, we believe that the regulatory system is insensitive to the impact of regulation upon staff, the need for skilled staff to drive innovation and the need to encourage the future recruitment and retention of professional staff if networks are to meet consumer aspirations.

Question 2

23. We agree with the six principles set out in paragraph 2.8. However, we believe that the principle of not stranding efficient investment should have regard to the fact that during the process of innovation, networks will need to consider a range of options, of which some will become redundant. The current incentive system has encouraged a very conservative approach to innovation that has not served the long-term interests of consumers. We would therefore wish to see recognition that some stranded investment may result from innovation and that Ofgem will not penalise operators if such investment were prudent. Given the considerable environmental challenges facing the sector, a broad scope to innovation needs to be encouraged.

Questions 3 & 4

24. We support the wish to co-ordinate the review with other Ofgem initiatives and developments in national policy. Given the considerable prospects for change in both national and EU policy, it is important that the RPI-X project takes these developments

into account. We also welcome the intention to take a more open approach to alternative views and anticipate that this will lead to greater consultation with Prospect in future.

CHAPTER: Three – Setting the scene

Question 1

25. We believe that the original concept that light-touch regulation was only a stopgap before full competition could be introduced was a delightful intellectual fantasy. Networks are as close to a natural monopoly as possible and the benefits of competition to the consumer can only be achieved by clear and robust intervention to set a market with clear understanding of the desirable outcomes for the consumer. Therefore the original concept has largely lost what relevance it had to consumer aspirations as it fails to tackle the constraints of delivering public policy through privately financed and commercially-operated licence holders.

Question 2

26. Given the constraints caused by Government policy and incentive regulation, we believe that Ofgem has done a good job of trying to reconcile a poor framework with the pressing need to improve network performance and investment. However we believe that the regulatory system has failed to address the three following issues since privatisation:

- The need to reconcile incentives for operational efficiency and prudent capital investment without creating false incentives to invest prematurely in new equipment;
- By restricting the focus to narrow cost analysis and rigid performance criteria, the process has ignored issues such as staff training and safety and misled stakeholders into believing that these issues are a much lower priority for Ofgem; and
- We believe that the system is largely insensitive to the need to recruit, retain and motivate skilled professional staff and by encouraging a very conservative approach to innovation and staff reward, RPI-x has discouraged talented staff from joining the industry in significant numbers. Whilst we are encouraged by the emergence of some very talented and innovative members in the sector since privatisation, we believe that this is despite the constraints forced by RPI-x and that more innovative talent is needed to meet the new challenges facing energy networks.

Questions 3, 4 & 5

27. Prospect believes that rigorous assessment of the impact of past practice, including the outcomes from DPCR5, is necessary to identify how robust the regulatory system is for the next twenty years. It is difficult to reach conclusions about the past effectiveness of regulation that are relevant to the current challenges facing the energy networks: therefore we would welcome an assessment that addresses the challenges set out in paragraphs 3.29 and 3.33. Given the considerable intellectual and creative involvement of Ofgem and stakeholders in DPCR5, we believe that the outcomes and debates that contribute to this price control should be considered as part of RPI-x@20.

CHAPTER: Four – Focusing on consumer needs

28. We agree that the long-term interests of consumers need to be the driving principle behind reform of networks regulation. Given the increased importance of networks to domestic and commercial life in Great Britain, a narrow focus on price is inadequate. We therefore welcome the wider range of issues identified in paragraph 4.15. Innovation is crucial to addressing these complex and sometimes contradictory goals and we would wish to see the reformed regulatory system provide more freedom for skilled and professional staff in the industry to design, develop and test new practices so we can assess a full range of options to meet future consumer aspirations. The excitement in innovation and pride in consumer service are two of the key cultural strengths of this sector and we believe they should continue to be encouraged.

CHAPTER: Five - Delivering a sustainable energy sector

29. We agree that sustainability is vital and that Ofgem should ensure that energy regulation meets the following sustainable goals: social targets, security of supply and environmental objectives. Further exploration of the issues set out in paragraphs 5.27 to 5.31 is necessary so we may find the right balance between risk and reward and encourage realistic innovation and further prudent capital investment.

CHAPTER: Six - Ideas for further exploration

30. We strongly oppose further deregulation of the sector as there is a need to ensure that income raised from consumers is invested efficiently. At this stage, we believe that a full examination of the challenges and issues facing energy networks should be completed before we speculate in detail about the shape of the new framework. We also believe that the regulatory system should consider the following three issues in greater depth:

- Training and development of the skills required up to 2030;
- Maintaining and improving safety standards in the sector;
- Creating the right incentives for staff to meet the challenges identified in this document.

31. Whilst we believe that terms and conditions of employment are rightly a matter for negotiation between operators and their staff, we are anxious to avoid Ofgem giving unintentional signals about the commercial structure of license holders and the employment of their staff. In particular, we are concerned that Ofgem may give signals about employment issues without full consultation with Prospect and other unions within the sector. The confidence and creativity of professional staff in the sector is key to its future success.

CHAPTER: Seven - Next steps

32. We look forward to continued consultation and dialogue with Ofgem on the RPI-X@20 process.

**Prospect
April 2009**

¹ Memorandum of Understanding

www.hse.gov.uk/aboutus/framework/f-mou_j.pdf

² New Industry, New Jobs - Building Britain's Future. HM Government, April 2009.