

Consultation on a potential RIIO-ED1 Mid-Period Review

Submission by Prospect to Ofgem

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Introduction

1. Prospect represents 141,000 engineers, scientists, technical specialists and managers across the public and private sectors, and is the union of choice in the UK for managerial and professional employees. For more than a century, Prospect, and its predecessor unions, has represented managers and engineers in the electricity supply industry, and as a result we can offer an invaluable, technically-informed perspective on the challenges and opportunities facing the UK electricity sector. Prospect routinely responds to consultations by Ofgem and other public bodies on issues relating to the electricity industry, and we continue to lobby for a sensible, informed approach to energy policy.
2. In summary, Prospect's view is that whilst there are issues with the regulatory framework that need to be addressed, especially around safety, investment, and skills, we believe strongly that an extensive MPR is not the right method to do this. We are very concerned that an MPR could become an exercise in crude cost control at the expense of a safe, resilient electricity network, and believe that revisions to the regulatory framework are best considered in the context of preparing for RIIO-2.

Need for a Mid-Period Review (MPR)

3. Prospect believes that there are serious problems with the current regulatory framework, as outlined in more detail below, particularly around the pattern of underspending, and on health and safety. Prospect members also feel, as we have stated before, that a defined output on skills and workforce development is needed given the employment pressures the sector is facing and the cuts to real earnings we have already seen in the first two years of RIIO-ED1.
4. However, we are concerned that the push for a more extensive review of the price control mechanism is being heavily motivated by a desire to tighten financial incentives and reduce costs for consumers, partly in response to a wave of recent negative press about the financial performance of network companies. Prospect believes that this risks exacerbating the tendency to reduce the policy debate around network regulation to a simple zero sum game – the gains go either to consumers or to shareholders, with little consideration for the energy workforce, or the longer term interests of the UK energy system.
5. Network companies are traditionally very risk-averse and their investors expect regular, predictable returns. Prospect believes that if financial incentives are tightened up, it is likely that, given the current regulatory framework, the DNOs will be pressured by their investors to simply cut costs further in order to preserve their operating margins. Critical spending in areas like infrastructure investment, workforce training, employee remuneration, and research and development could all be significantly affected, ultimately to the detriment of consumers. Prospect members are not at all confident that the existing design of RIIO outputs is robust enough to ensure that lower revenues do not translate into lower investment. The existing pattern of underspending in certain parts of the sector is already troubling and further cutbacks would risk leaving our energy networks woefully

underprepared for the challenges of the future, and could ultimately lead to higher costs for consumers.

6. As a result, Prospect believes that an MPR would not be appropriate and could risk exacerbating the problems with the current regulatory framework. Just as we voiced concerns about using crude mechanisms like price caps in the retail electricity sector, we have similar concerns about the potentially dangerous impact of trying to drive down costs in an unsustainable way. Doing so will at best only lead to short-term gains for customer bills at the expense of significant cost increases in the medium to long term. We believe therefore that it would be more appropriate to consider changes to network regulation in the context of planning for the next price control period, RIIO-2.

Network Performance Under RIIO-ED1

7. Despite the improvements introduced by the RIIO framework, Prospect remains concerned that there are important deficiencies in the regulatory regime for the UK electricity supply industry. As we stated in our response to the opening consultation for the RIIO-2 price control, our members believe strongly that the current framework privileges cost control and reducing bills for consumers to the detriment of other metrics, especially on health and safety, skills and workforce development issues, and investment in network infrastructure. Given the dramatic changes the industry has witnessed, and continues to witness, we remain unconvinced that the RIIO framework is adequately preparing the UK power system for the demands of the future.
8. We now have two annual reports on company performance under the RIIO-ED1 framework, and the data offers troubling reading. Whilst in overall terms, cumulative spending across all the DNOs has been 7% below allowances between 2015 and 2017, Prospect notes that spending in certain key cost categories such as replacing and refurbishing equipment and network reinforcement has been even lower, with underspends of 21% and 37% respectively. At the same time, the DNOs have overspent on dealing with network faults by 13%.
9. Some of this underspend may be due to increased efficiencies, and higher spending on faults is due in part to storms last winter, but the overall pattern raises troubling questions about whether DNOs are replacing long-term, proactive infrastructure spending with short-term, reactive spending to patch growing problems with an aging network and avoid the penalties associated with missing targets on outputs like customer minutes. For Prospect members, one of the key concerns is that the existing regulatory framework encourages and rewards this type of cost-cutting behaviour in network companies, at the cost of reduced investment and innovation. This replicates the defects with previous price controls.
10. This pattern of under-spending is particularly troubling given the forecast for increased demand resulting from developments such as the growth in the use of electric vehicles, and the continued expansion of distributed generation which National Grid has estimated could comprise more than a third of total generation by the end of RIIO-ED1. With government climate policy requiring significant further steps towards the electrification of both transport

and heating in the coming decade, preparing our networks for a radically different operating environment will be essential, and the initial data suggests that regulation is not sufficiently incentivizing network companies to prepare for these developments.

11. One particularly troubling expression of this is the pattern of under-investment in IT, a cost category with one of the biggest rates of underspending. Across the DNOs as a whole companies have underspent on IT equipment and services by an average of 40% so far in RIIO-ED1. Given the near-universal belief that the transition to smarter networks will require a qualitative improvement in the use and management of big data by the DNOs, and the fact that integrating new IT systems and training staff to use them effectively can take time, it is concerning that networks appear to be underspending to such a significant degree in this area at this point in the price control period.
12. Prospect is cognisant of the fact that direct expenditure has typically been lower in the initial years of previous price control periods and then grown in future years. However, given the unprecedented level of change the electricity industry is facing, past practice is not necessarily a suitable guide for current behaviour, and Prospect members are concerned that the DNOs have insufficient incentive to prepare for the radically different roles that distribution networks will perform in the future energy system.
13. Prospect members have also taken note of the fact, reported in the latest RIIO-ED1 annual report, that DNOs are delaying investment decisions because of economic uncertainties, driven in part by the Brexit process, and concerns about adequate skill levels.¹ With respect to skills shortages, this has been a serious issue for the electricity industry for some time, with key shortages of workers with critical engineering skills a major problem for the sector. A recent survey of industry executives found that almost 50% expected a serious skills crisis to develop in the next 3-5 years unless significant action is taken. If DNOs are delaying investment decisions because of skills issues, both with direct staff and contractors, this should be a wake-up call for regulators and industry stakeholders.
14. The growing problem around skills shortages is exacerbated by the decline in real pay in the electricity industry in recent years. Based on annual earnings data from ONS, real median pay in the electricity distribution sector has fallen by £2,276 (5.9%) since the start of the RIIO-ED1 price control in 2015. Despite this, network companies continue to enjoy high rates of profit, and there are no explicit mechanisms to ensure that the DNOs do not squeeze workers' pay in order to meet their expenditure targets. Given the recruitment problems and skills shortages in the industry, this is a major cause for concern.
15. Prospect members have also reported growing concerns about deskilling, with complex work, previously carried out by qualified and experienced engineers, being carried out by less qualified staff without adequate supervision. This has obvious safety implications, and

¹ Ofgem RIIO-ED1 Annual Report 2016/17 p20

connects with the serious concerns Prospect members continue to have about some of the health and safety practices in the electricity industry.

16. We have said in the past that Ofgem's belief that health and safety is essentially a matter for the HSE ignores the central role that price regulation plays in shaping the environment in which workers operate by setting targets without any assessment of safety and not addressing the skills issues that are key to safe working practices. Our members continue to report that aggressive efforts to meet targets in areas such as customer minutes lost and connections frequently override concerns about health and safety.
17. The headline numbers on health and safety do not bear out Ofgem's consistent assessment that there are no major health and safety issues affecting the industry. The latest statistical release from HSE shows that the rate of fatal accidents over the last five years in the combined electricity and gas sector is almost twice the national average, and in 2016/17 was higher than the level seen in construction, traditionally seen as a dangerous industry. These figures include both gas and electricity utilities, but it is likely that the electricity industry is a substantial contributor to that rate. And, although the national data that currently exists is limited, rates of ill-health and stress also appear to be above the national average. Prospect has also been made aware that the HSE has serious concerns about some of the current health and safety practices in the industry, particularly regarding staff competence in the wake of a significant loss of skills, and now feels that lighter-touch safety regulation may no longer be appropriate.
18. Prospect is concerned that the design of the price control framework may be contributing to health and safety problems, and we believe that there is a pressing need to assess the health and safety implications of the output targets in the RIIO framework. We do not believe it is sufficient for Ofgem to leave these critical issues to the HSE, and there needs to be much better coordination between regulatory bodies to ensure that the actions taken by one (for example by setting more stringent financial targets) do not undermine the efforts of the other.

Conclusion

19. As outlined above, we have significant concerns about the current shape of network regulation. However, we are also very concerned that an MPR will be used as a mechanism to push further cost reductions at the expense of other measures of performance. Therefore Prospect does not believe a wide-ranging MPR would be in the best interests of the industry or its workforce, and that problems with network regulation are best addressed in the context of planning for RIIO-2.
20. Prospect welcomes the opportunity to contribute to this consultation exercise, and we firmly believe that the regulator needs to engage with workforce representatives in a much more sustained and consistent manner between formal price reviews to meet its statutory duties, ideally through the creation of an ongoing trade union consultative forum.