

Consultation on the RII0-2 Price Control Framework

Submission by Prospect to Ofgem

18th August 2017

Introduction

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 we have a unique insight into the challenges and opportunities facing the UK electricity sector as it develops in response to a range of economic, environmental, and engineering challenges. As a result, we believe it to be essential that the collective expertise and experience of our members is given a central place in the formulation of the next phase of the price control framework.

Whilst network regulation has been successful in some respects, experience over the past thirty years has also clearly exposed the limits of the market and the intense pressures privatisation has placed on regulation and investment. In particular Prospect believes that privatisation has led to a heavy focus on cost efficiency, often at the expense of other policy objectives, and the UK urgently needs a new, rebalanced energy policy that not only provides a fair deal for consumers, but also guarantees the kinds of reliable, safe, and low-carbon energy networks that are an essential prerequisite for economic development in the twenty-first century. Energy policy also needs to be more cognisant of the fact that these policy objectives will only be achievable if the sector has the skilled workforce it needs to be successful. Crucially, a sustainable energy policy cannot be delivered through one-off initiatives and ad-hoc measures to tackle issues such as shortfalls in training or inadequate levels of technical innovation, and effective coordination of energy regulation with broader government policy, especially the government's industrial strategy, is essential to ensure that our future energy needs are adequately and efficiently met.

Prospect believes strongly that energy policy and industrial strategy are closely intertwined, and it is vital that this is taken into account in the regulatory process. Energy networks are part of the critical infrastructure necessary for economic growth, and issues such as skills shortages in the energy sector act as an impediment to broader industrial development whilst also preventing the UK realising the full value of its energy resources and networks. This is especially important in the context of a highly lucrative global market for energy services in which the UK needs to be a major actor. Ensuring that energy networks can deliver services that help maximise industrial growth requires coordinated thinking and long-term planning by government, regulators, industry actors, and representative bodies like trade unions.

It is also critical to ensure that the geographical dimension of the energy industry is given appropriate consideration in energy regulation and industrial strategy. Due to its reliance on natural resources and established skills clusters, the energy sector is concentrated in specific geographical locations where it is a major employer, so changes in energy policy also require an adequate assessment of the regional impact. Given proper support and attention, regional energy clusters have the potential to become specialist centres for research, engineering, and service delivery expertise that can be drivers of regional economies. There is therefore a strong need to create better links and stronger lines of communication between industry stakeholders, regulators, and regional and national government, so that commercial knowledge and expertise can be shared, and policy can be developed in a way that allows the sector to effectively contribute to regional and national economic growth.

Prospect also remains concerned about the desperate level of skills shortages in the UK energy sector, exacerbated by an aging workforce and a rapidly developing industry facing significant technological changes. Consumers increasingly expect energy networks to operate in more innovative, efficient, and flexible ways, while changing patterns of generation are creating new challenges for our networks. Significant research, development, and integration will be necessary as we adapt to these new realities, and this cannot be achieved without a skilled workforce. It is essential, therefore, that skills shortages, and workforce development issues more broadly, are given a prominent place in energy regulation. An ongoing shortage of key skilled workers will only hamper efforts to deliver the kind of efficient and flexible energy networks that consumers demand, and which modern economic activity requires.

We know from our long experience representing workers in the sector that meeting our collective goals for the energy sector will depend upon the commitment and expertise of network staff. To ensure that we can recruit and retain staff in sufficient numbers, Prospect believes that we need to see a combination of revenue and incentives that deliver high health and safety standards; allow for excellent professional training to boost innovation and technical excellence; and provide sufficient revenue to enable the maintenance of a competitive remuneration package, including pensions, for professional staff with scarce technical skills.

Finally, Prospect believes that the challenges of technological change, changing patterns of energy usage, and new demands from consumers, require employers, regulators, and unions to cooperate closely and develop new approaches to working practices. Prospect has much to offer in this regard, and we look forward to a fruitful engagement with both Ofgem and the network companies to develop a robust, effective, and fair price control mechanism.

Our submission below responds to some of the questions raised by Ofgem in the consultation open letter.

Key Consultation Questions

Do you agree with our overarching objective for RIIO-2 and how we propose to achieve it?

Prospect recognises that UK energy networks are entering a virtually unprecedented period of change. Patterns of generation and demand are shifting rapidly, new, potentially revolutionary technological innovations are in various stages of development, and there is a high degree of broader political and economic uncertainty. As such, we share Ofgem's desire to ensure that RIIO-2 properly takes account of these circumstances and incentivises network companies to proactively and effectively adapt to them. We are also cognisant of mounting public concern over the value delivered by network companies, which we believe is in part driven by the complexity of the regulatory process which makes it more difficult for consumers to understand the critical role played by transmission and distribution companies within the broader energy sector. We therefore welcome any steps towards simplifying the price control framework, insofar as that doesn't come at the expense of other regulatory goals.

More broadly, Prospect notes that market approaches to energy supply have a mixed record, and the UK experience since privatisation does not paint a uniformly positive picture. We are not convinced that competition, especially in inherently monopolistic parts of the sector such as transmission and distribution, is always the most effective way to deliver network services efficiently and cost-effectively, especially in areas where there is no clear benefit to consumers. We feel that it is important therefore that any ideological commitment to free market competition on the part of government does not translate into a formula for energy regulation that only serves to drive up costs, limit investment in infrastructure and skills, and hamper efforts to deliver network services in a safe and reliable manner.

Fundamentally, Prospect believes that very careful thought will be need to be put in to ensuring that the component elements of Ofgem's overarching objective for RIIO-2 do not conflict with one another, and that the drive to ensure cost efficiency does not crowd out other policy goals as we believe it has done in the past. In particular, any re-examination of the returns enjoyed by network companies must make appropriate allowance for the need to:

- a) seriously tackle the chronic skills shortages the energy sector faces, especially in the context of a shift to 'smart' networks which, as the National Skills Academy for Power has noted, will bring new, more complex skills challenges;
- b) address the significant rates of ill-health among network staff, and ensure health and safety regulation is equipped to cope with the new safety challenges that smart networks will present;
- c) develop a more robust culture of innovation, especially as new patterns of generation and demand have greatly increased the pace of change in the sector;
- d) ensure that network companies are directing sufficient investment into the networks in order to meet the requirements of a twenty-first century economy, given that reliable, flexible, and safe networks are an essential prerequisite for economic growth.

In basic terms, a tightening up of the regulatory regime must not lead to a counter-productive outcome where network companies seek to preserve operating margins by making unsustainable cuts to critical areas of expenditure. It will therefore be crucial to ensure that an appropriately robust array of incentives and penalties allows revenues to be channelled in an efficient and cost-effective way that meets the broader goals for the sector.

How can the outputs framework be improved, including the introduction of additional output categories for example around efficient system operation for distribution network companies?

Health and safety issues have always had a place in the price control framework, a fact which Prospect has welcomed. However, we remain concerned that the scope and type of incentives attached to this output are insufficient to ensure that health and safety issues are truly central to how the network companies do business. Whilst we acknowledge that health and safety compliance is primarily an issue for the Health and Safety Executive, we feel strongly that this does not prohibit Ofgem from taking a more robust view of health and safety in order to complement the work of the HSE. We believe that energy consumers have an interest in seeing safe, healthy working conditions in the industry, in line with growing societal concerns over ethical labour standards. There are also potentially significant financial benefits to consumers in ensuring a safe and healthy work environment, as this is strongly linked to improvements in productivity, which in turn can help to lower network costs.

An improved focus on health and safety issues is particularly important given that the ENA has acknowledged that rates of ill-health in the electricity industry are significantly above the average for industry as a whole, while mental health issues are now the leading cause of lost work days in some network companies. Prospect believes that it is essential to ensure that the design of RIIO-2 does not contribute to high rates of ill-health in the electricity industry, and works in a way that promotes healthier working conditions. We feel that it is vital that steps are taken to ensure that network operators tackle this problem in a proactive, timely and serious way.

Additionally, the development of 'smart', more complex networks will bring with it new kinds of safety challenges, and safety defects will have an increased impact on system efficiency. Given this, we need to ensure there is an adequate focus on proactively identifying and preventing potential incidents, which will in turn require a resilient workforce with the right kind of skills. More broadly, we need to build the kind of safety culture, similar to that in place in sectors such as the civil aviation industry, where safety measures, and the proactive reporting of health and safety problems, are accepted as a normal part of working practice, rather than something prompted by the risk of financial penalties.

As a result, there are a number of specific amendments to the safety output that Prospect would like to see put in place for RIIO-2. In particular, we would like to see health and safety built into the RIIO framework in a more comprehensive way, by requiring a health and safety assessment of each output target, particularly in categories such as reliability, connections, and customer service. This would ensure that target-setting is undertaken in a way that takes health and safety issues seriously, and results in targets which can be achieved without compromising the safety and well-being of the workforce and the public.

Prospect would also like to see a specific allowance put in place for health and safety training, similar to the allowance provided for in DPCR-5, to ensure that funding in this critical area is adequate and is appropriately ring-fenced to ensure resources are not diverted to other uses. This is especially important given Ofgem's stated desire to tighten the financial regime in RIIO-2, and we feel that steps need to be taken to ensure that network companies are not pushed to reduce expenditure in areas such as health and safety training in order to preserve operating margins.

We would also like to see a specific health and safety target put in place that requires the network companies to ensure that, as a minimum, rates of ill-health and accidents do not exceed the average rate across industry as a whole, and we would like to see further progressive targets put in place for continued reductions over time in days lost due to ill-health and accidents for each network company. This will likely require the gathering of up-to-date statistics on rates of accidents and ill-health in the sector, in order to establish reliable benchmarks against which targets can be set.

More fundamentally, Prospect believes that the 'safety' output needs to be defined more broadly as a 'working standards' output that incorporates health and safety issues, but also looks more widely at labour standards and working practices. Again, Prospect believes there is widespread interest among consumers in ensuring that the products and services they use are produced and delivered in a way that meets minimum ethical standards, in addition to the proven link between high labour standards and productivity, which can help lower costs for the industry and deliver greater value for the consumer.

To this end, Prospect believes that a code of practice should be put in place for both network companies and contractors, requiring them to uphold and maintain good working practices. In addition to compliance with all relevant labour legislation, as well as health and safety regulations, this code of practice would impose a requirement to ensure high levels of employee job satisfaction, to meet targets for improving the diversity of the workforce, and would encourage network operators to become leaders in workforce development and training, an issue which we take up further elsewhere in our submission. Prospect would like to see this code of practice implemented as a mandatory requirement for operating in the sector, with financial penalties for failure to meet the stipulations of the code.

What constitutes a fair return for a regulated monopoly network company, and how can we ensure that returns remain legitimate in the eyes of stakeholders?

Prospect is cognisant of the public interest and concern with the level of financial returns and profit margins enjoyed by energy companies, and recognises the need to carefully re-examine the financial framework in which network companies operate. However, Prospect is concerned that efforts to tighten up the price control regime, and limit the returns network companies are allowed to earn, must not translate into reduced investment in the networks or curtailment of expenditure in vital areas such as health and safety in order to preserve operating margins. It will be vital to ensure that RIIO-2 is designed in such a way as to set network company returns at a fair level, whilst at the same time ensuring robust, appropriate levels of expenditure, with an associated structure of incentives and penalties, in critical areas such as capital investment, research and development, staff remuneration, skills training and workforce development, and health and safety.

We also recognise that perceptions of risk are the key drivers of capital costs, which in turn play a central role in setting prices. Prospect believes it is essential that Ofgem sets out a clear financial regime that eliminates regulatory uncertainty from the risk equation, and which is flexible enough to allow for amendments to revenue allowances in the event of unforeseen circumstances which are beyond the network companies' control.

Have the incentives inherent in the RIIO model encouraged network companies to be more innovative and what should we consider further?

Prospect believes strongly in the need to foster a culture of innovation within the energy networks, especially in a context in which the energy sector as a whole is facing virtually unprecedented levels of change and uncertainty, with rapid developments in the scope and costs of new energy technology. As a union which represents engineers, scientists, and other specialists, Prospect members will be closely involved in efforts to design, test, and implement new energy technology.

Prospect is concerned that the existing mechanisms within RIIO-1 do not do enough to encourage the kind of speculative projects and risk-taking that is necessary for true innovation to occur. As things stand, the take-up of funding allocated for innovation has not been particularly strong, and during the first year of RIIO-ED1, for example, only 56% of Network Innovation Allowance funding was used by the network companies. Prospect believes this is linked to the fact that the current framework tends to encourage relatively safe, low-risk projects, which have a high chance of success, and this does not allow the industry to learn the deeper and often more useful lessons that come from riskier projects which have less certain outcomes. A framework that encourages network companies to experiment with radical new solutions to problems will be essential to meeting the technological challenges the industry faces, and such a framework will need to recognise that the potential financial gains from new technology are often realised over a much longer timescale than the RIIO-2 period.

It will also be crucial to recognise that there is often a tension between experimenting with new technological solutions and meeting stringent targets in areas such as customer minutes lost and connections, and if there are going to be meaningful measures to encourage a more robust culture of innovation, as Prospect believes there should be, there may be a need to be flexibility on some of those targets built in to the innovation incentives, especially in cases where innovation offers the potential to deliver significant long-term benefits.

Prospect would therefore like to see an innovation framework that promotes an appropriate degree of more speculative, long-term thinking around innovation, and which encourages network companies to be more experimental in the design of their innovation projects. Prospect is proposing that the best way to achieve this outcome will be the establishment of an expert technical panel, with a voice for key industry stakeholders, which will have responsibility for approving innovation funding to network companies, on the condition that any new intellectual property is shared across the sector. Such a panel would help ensure that funding is well-spent, offering good value to consumers whilst also helping to push the frontiers of energy innovation.

Do you agree that the scope of competition should be expanded in RIIO-2? What further role can competition play?

Prospect does not believe that competition is automatically the most effective mechanism for ensuring safe, reliable, and cost-effective outcomes, especially in a sector characterised by the presence of natural monopolies. Prospect notes that while competition has been more successful in areas where there is a clear benefit and choice for consumers, such as connections, in other areas, such as the OFTO regime where final consumers do not have a real choice, the picture is less positive. The introduction of competition into offshore transmission has attracted criticism in the past from the House of Commons Public Accounts Committee (PAC) for granting overly generous terms with minimal risk to investors, leaving consumers to assume the risks of these projects. PAC also noted that the OFTO market has also been dominated by two or three consortiums of large investment firms, and the extent to which true competition has been introduced into offshore transmission is open to question. The National Audit Office has also warned that cost savings from OFTO licenses are not guaranteed and may not materialise. More broadly there are concerns that introducing competitive mechanisms like OFTO makes it harder to plan and coordinate network development efficiently and effectively. For these reasons, Prospect is sceptical about whether extending competition to onshore networks is desirable and questions whether it will lead to improved outcomes for consumers.

Do you agree with our broad stakeholder engagement approach?

Prospect welcomes the approach to stakeholder engagement outlined by Ofgem, and is particularly interested in participating in the working groups on 'responding to the wider changes in how networks are used' and on 'efficient delivery solutions and innovation.' However, we also feel there is a need for at least two additional working groups, one covering 'health, safety and working practices' and another on 'skills and workforce development'. Prospect believes establishing these additional groups will be necessary to help develop appropriate measures within the regulatory framework that address these critical areas, along the lines we have outlined in our submission, and we would be keen to participate in both of these working groups.

Additional comments

Skills and workforce development

Prospect is concerned that skills and workforce development issues were absent from Ofgem's open letter on RIIO-2. Given the focus on innovation, the scope and pace of change in the sector, and high levels of uncertainty about future energy scenarios, the energy sector faces tremendous challenges to ensure that it is recruiting and retaining sufficient numbers of workers with the right mix of skills, and that the full potential of the energy workforce is being realised. According to the National Skills Academy for Power (NSAP), 1 in 5 skilled workers in the electricity distribution industry will retire or leave the sector before the end of RIIO-ED1, and in an environment where a growing number of companies, especially in the renewables sector, are looking to recruit from the same shrinking pool of skilled workers, the challenge of ensuring adequate, safe levels of skilled staffing is set to become acute.

In this context, Prospect believes it is essential to ensure that adequate revenue streams are put in place to; a) ensure competitive remuneration packages for network staff, including good pension benefits; and, b) provide funding for skills training and workforce development. Adequate remuneration will be essential if skilled staff are to be retained, especially in a context where the labour market, especially for skilled engineering talent, is exceptionally tight.

Funding for skills and development needs to be targeted towards helping to both bring in new skilled workers through, for example, funding increased numbers of apprenticeship and graduate training schemes, and also developing and reskilling the existing workforce. There is also a need to plan for the new skills challenges arising from the shift to smarter networks that is likely to accelerate during RIIO-2, and NSAP has indicated that a more interactive, responsive, and flexible grid will require an increase in higher level STEM skills in areas such as system planning, cyber-security and communications engineering. Ensuring that those kinds of degree-level skills are developed in adequate numbers to meet industry needs will require not only adequate funding, but also a coordinated approach by industry stakeholders, the regulator, and government.

We believe that it is essential that funding for both staff remuneration and skills training and workforce development is clearly identified and ring-fenced to mitigate any risk that funds are underutilised or redirected for other purposes, especially given Ofgem's stated intention of tightening the financial regime for RIIO-2. Skills and workforce development funding will also need to be set at an appropriate level to ensure that companies have the resources they need to meet the challenges they face, and to this end it will be important to update existing workforce projections, and commission new assessments of workforce needs where appropriate.

Prospect feels there is also scope for Ofgem to introduce specific targets for the network companies to meet around skills training and workforce development, with an appropriate structure of incentives and penalties to encourage good performance. Ensuring adequate, safe levels of staffing is not something that can simply be left to chance or to the market, and will require careful planning and coordination, and it is therefore vital that RIIO-2 makes this issue a key priority.

Engagement with workers

Prospect believes that there needs to be a mandatory requirement for network companies to engage with and consult workers on their business plans and on their approach to meeting the requirements of the price control framework. The energy sector is likely to witness a continuing high degree of change and uncertainty during the RIIO-2 price control period, and fostering a meaningful and respectful dialogue between unions and employers will yield significant benefits by helping to ensure that disruptive processes of change are approached in a way that enjoys the maximum possible support and engagement of the workforce. Unions like Prospect have a wealth of knowledge and experience, especially on critical issues such as skills training and health and safety, and can contribute meaningfully to discussions on how best to meet targets in these areas. Prospect would therefore like to see a mechanism for meaningful workforce engagement built into the RIIO-2 framework, ideally by requiring that employers meet with recognised unions on a regular basis to consult on all issues related to the price control regime.