Consultation on the RIIO-2 Framework

Joint Submission by Prospect, Unite the Union, GMB, and Unison

April 2018

Introduction

Prospect, Unite, GMB and Unison collectively represent tens of thousands of workers across the electricity and gas supply sector. Our members work at every level of the industry and have a wealth of expertise and experience stretching back decades. At this critical juncture for the energy industry, which faces a virtually unprecedented set of challenges and disruptive forces, we have been moved to submit a joint response to Ofgem in the hope that the collective weight of our members can lead to a substantial rethinking of some of the serious shortcomings of the framework proposals for RIIO-2.

The RIIO-2 framework consultation comes at a time of active national debate on the future of privately-owned energy networks, as well as mounting public concern about the apparently generous returns enjoyed by network companies. A growing number of people are coming to question the belief that markets can deliver reliable and affordable energy, whilst also ensuring decent, safe, and fairly remunerated working conditions. We do not believe that to date Ofgem has so far made the case that regulated markets can deliver for workers and consumers. The proposals outlined in the framework consultation document fail to adequately grapple with the major challenges facing the industry, and we doubt they will be sufficient to allay public concerns.

We believe that experience over the past thirty years has clearly exposed the limits of liberalised free markets and the excessive focus on cost cutting, which has frequently come at the expense of other policy objectives. As we detail below, pay, safety, and workforce development and renewal have all been undermined even as investor returns have grown rapidly. At the same time, Ofgem has failed to adequately and routinely consult the energy workforce in a manner consistent with the regulator’s close working relationships with network companies. This is particularly unfortunate given the rich experience and expertise of our members and their place on the frontlines of service delivery which gives them an invaluable perspective on the successes and failures of the regulatory regime.

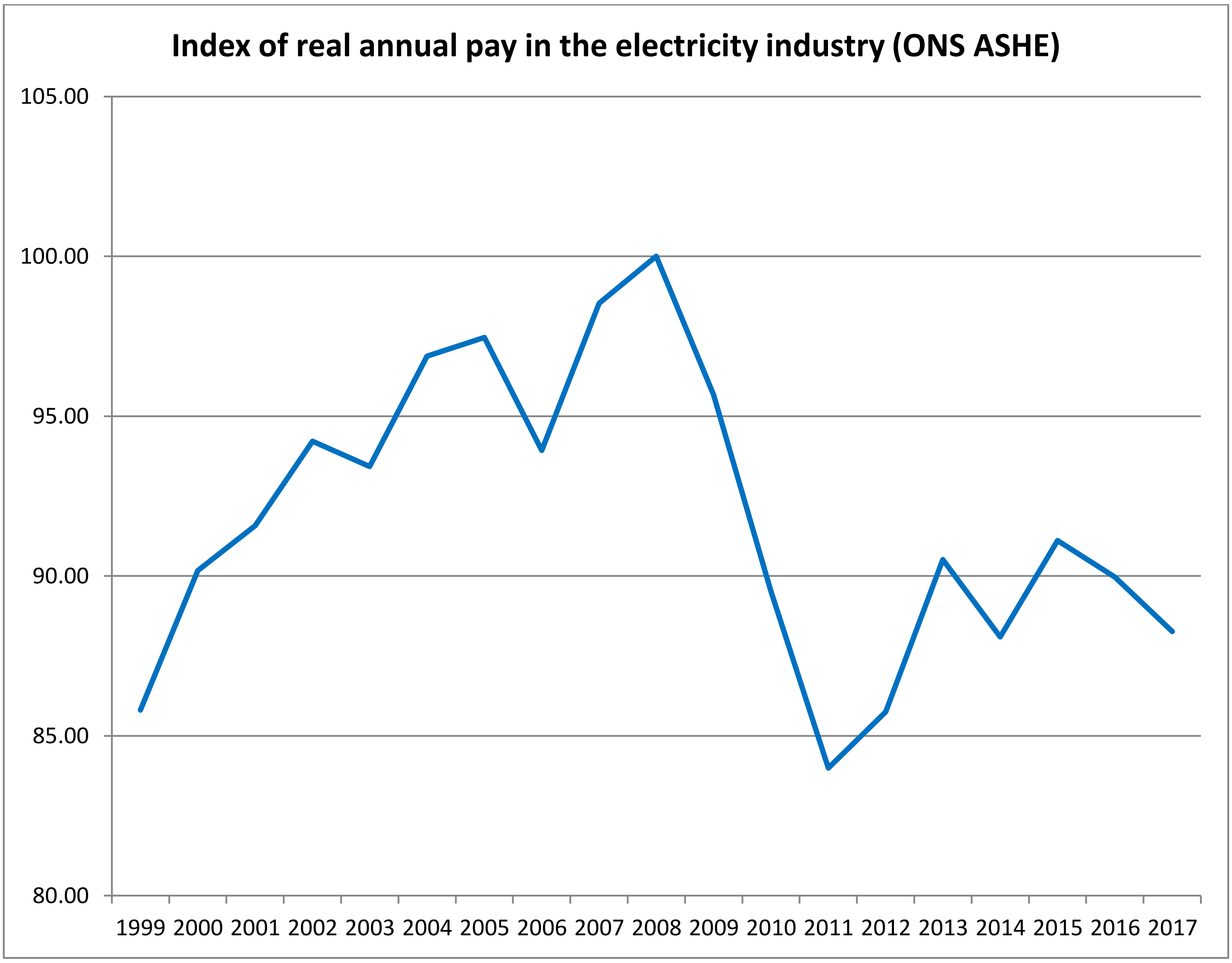
We feel strongly that if regulated markets are to survive and regain widespread public confidence then they have to demonstrate that they can operate in a way that is truly in the broader public interest. There is a pressing need for network regulation, and energy policy more broadly, to abandon a fixation that marketization and liberalisation are automatically the most effective means of delivering essential public goods like energy. We sincerely hope that Ofgem will heed the growing popular mood for change, and reimagine the price control framework in a much more holistic, and evidence-driven way.

Our response to the RIIO-2 consultation highlights the key areas where we feel the framework proposals are particularly deficient, especially with respect to workforce remuneration, skills shortages, health and safety, and workforce engagement.

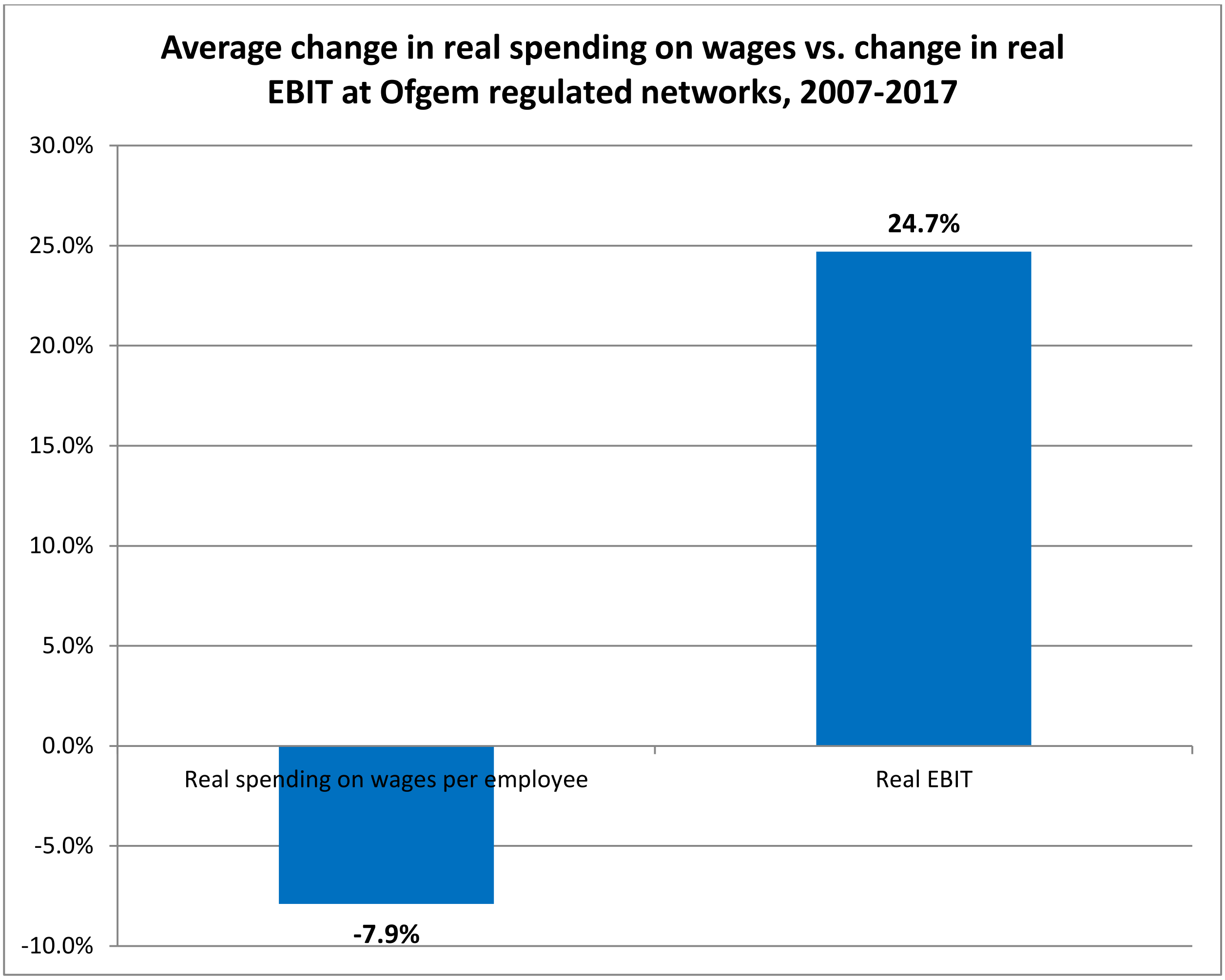
Pay

National data on pay in the electricity industry shows that pay has fallen significantly in real terms over the last decade. Ofgem have consistently failed to ensure that network companies do not hold down pay levels in order to boost corporate earnings, despite Ofgem's own analysis suggesting this is precisely what has been happening.

ONS data on average annual pay in the electricity industry, taken from the Annual Survey of Hours and Earnings, show that in real terms pay has fallen significantly over the past decade. And, despite a limited recovery between 2011 and 2013, since the start of RIIO-1 real average pay has resumed a downwards trajectory.

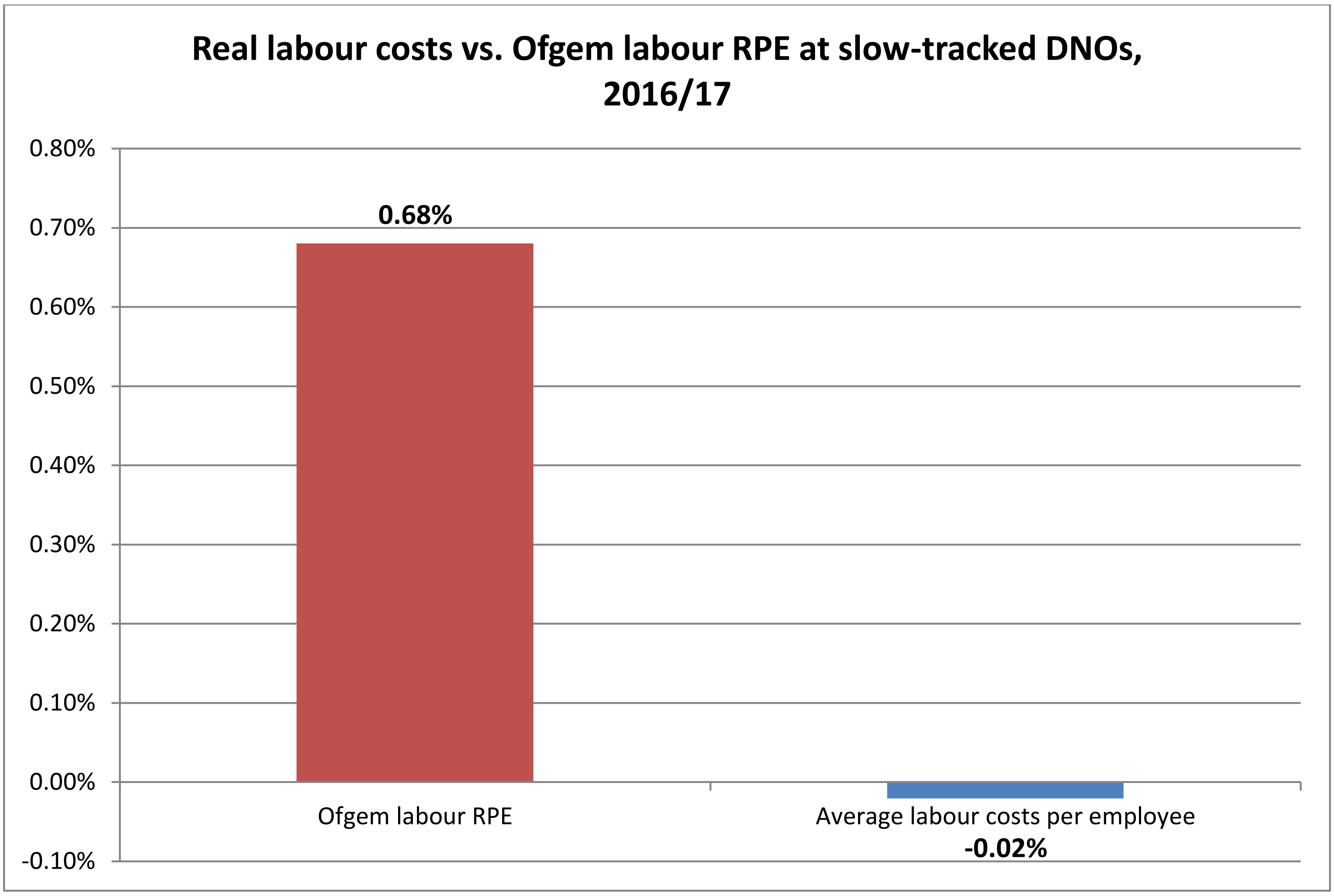


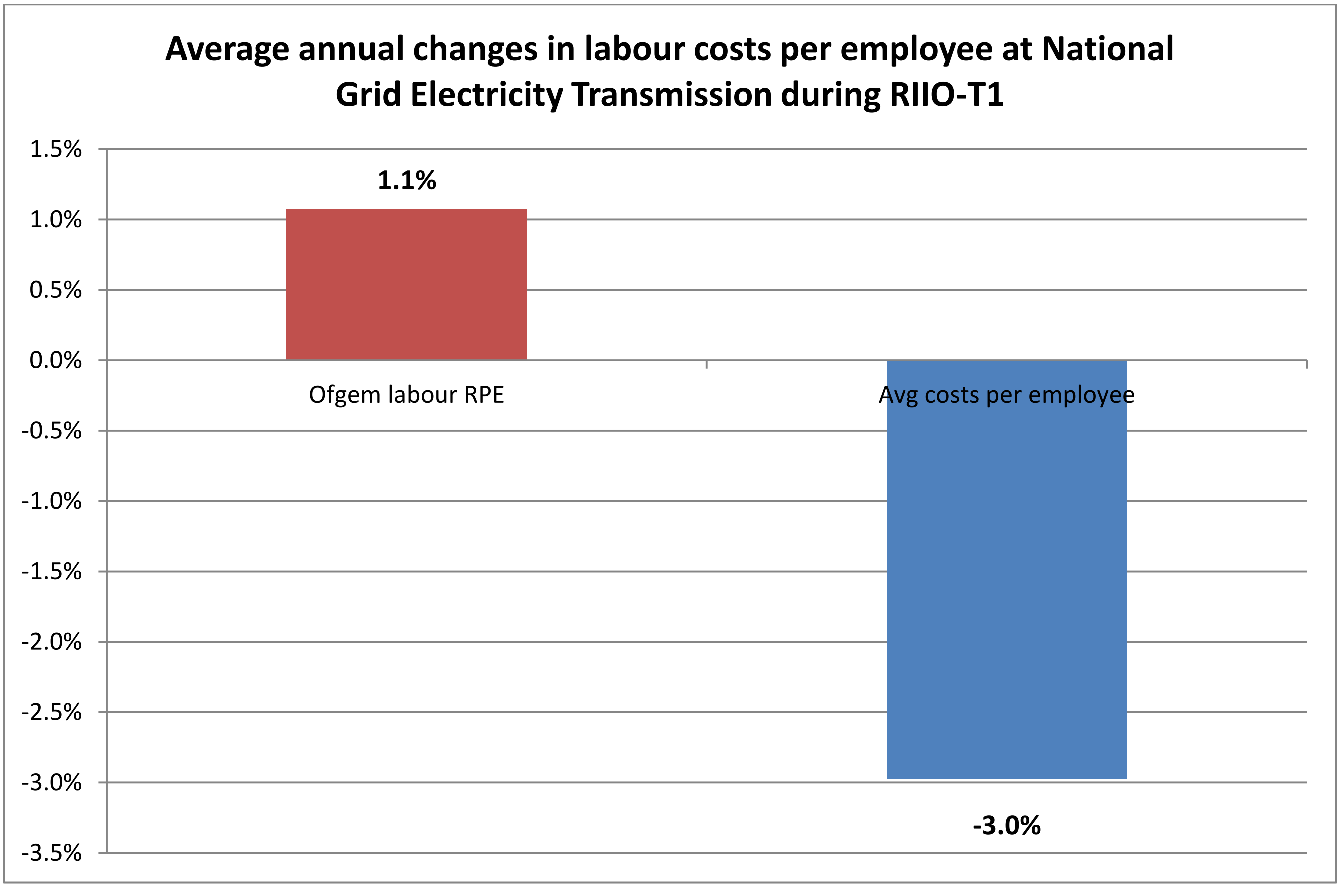
Data from the network companies own financial reports further underscores this trend of falling real pay, even as corporate profits soared. Between 2007 and 2017, over the course of three different price control periods, the trend has been stark and consistent: average real spending on wages per employee fell by almost 8%, while real EBIT grew by almost 25%.



So far during RIIO-1, the signs are that this trend is continuing. Despite Ofgem increasing totex allowances to allow for real labour cost increases, and despite the repeated arguments of network companies during the consultations on the RIIO-1 framework that these allowances were not sufficiently generous and would harm recruitment and retention, spending on labour has, on average, actually declined in real terms.

This is particularly stark in the case of the transmission price control for National Grid, where real spending on labour costs per employee have fallen by an average of 3% a year, despite allowances for real terms increases in labour spending. Ofgem have acknowledged that National Grid have benefitted from underspending relative to real price effects by around £480 million, of which underspending on labour costs has earned the company an estimated £158 million. Based on the CEPA analysis of RIIO-1 performance commissioned by Ofgem, this underspending on labour has amounted to the equivalent of around 0.25 percentage points to National Grid’s baseline return on equity.


Real labour costs vs. Ofgem labour RPE at slow-tracked DNOs, 2016/17
0.80%
0.70%
0.60%
0.50%
0.40%
0.30%
0.20%
0.10%
0.00%
-0.10%
0.68%
Ofgem labour RPE
Average labour costs per employee
-0.02%


Average annual changes in labour costs per employee at National Grid Electricity Transmission during RIIO-T1
1.5%
1.0%
0.5%
0.0%
-0.5%
-1.0%
-1.5%
-2.0%
-2.5%
-3.0%
-3.5%
1.1%
Ofgem labour RPE
Avg costs per employee
-3.0%

Ofgem’s traditional position - that it is not responsible for setting pay levels and that this is a matter for the ‘market’ to decide - is increasingly an untenable one. Leaving aside the point that because the companies in question are regulated natural monopolies it is Ofgem that determines the parameters of the ‘market’, there are at least two fundamental problems with Ofgem’s stance.

Firstly, Ofgem devotes considerable regulatory energy to influencing the earnings of corporate shareholders and bondholders, and is (quite rightly) not content to allow the ‘market’ to set the returns enjoyed by investors. It is not at all clear why the same should not also apply to the returns to labour, particularly given the industry’s heavy reliance on increasingly scarce specialist labour.

This relates to the second key issue. Ofgem continues to preside over a chronic and worsening skills landscape in the electricity industry, and the declines in average real pay will only serve to exacerbate that situation. Our deep concerns about skills are addressed further below, but in short available evidence shows that the sector is struggling to attract sufficient numbers of skilled staff, even as the demographic profile of the workforce means that tens of thousands of new hires will be needed over the next decade just to replace retiring workers.

In recognition of the challenges the sector faces, the chief executive of the Energy and Utilities Skills Partnership has recently called on Ofgem to put skills needs at the heart of the RIIO-2 framework (Utility Week, 15/08/17). Yet, to date, the framework proposals put forward by Ofgem make no mention of skills shortages or workforce development issues, and contain no proposals to deal with this critical issue in RIIO-2.

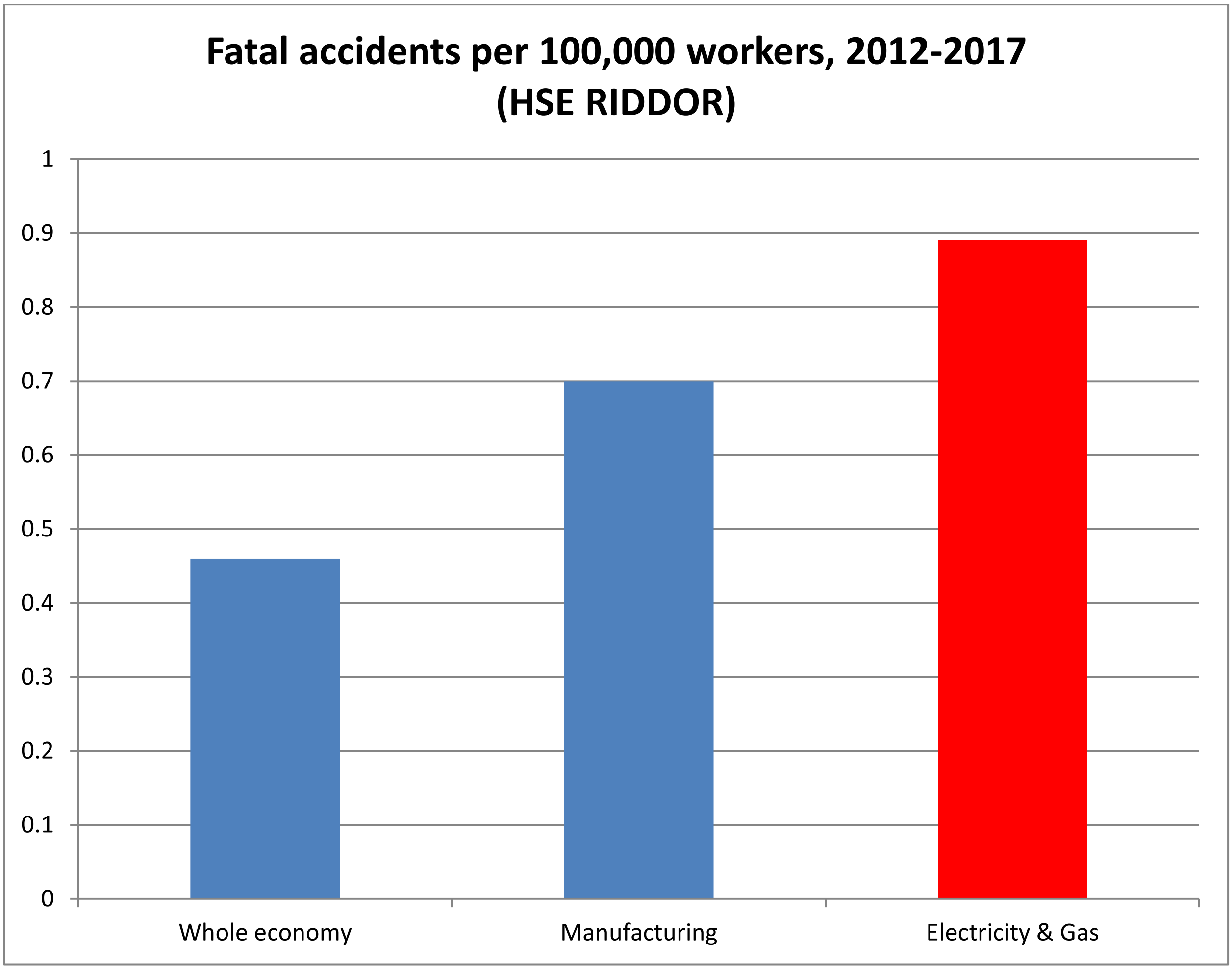
In contrast, Ofgem has expressed concern about the need to mitigate any potential negative impact on financeability resulting from measures to lower investor returns. Yet there has been no attempt so far to assess whether current returns to labour are fair or adequate for ensuring the future health and resilience of energy networks, or whether plans to reduce investor returns could have further negative implications for the returns to labour.

Ofgem is clearly applying double-standards in its approach to earnings, intervening to secure returns to investors, but failing to act to protect returns to labour. This demonstrates a worrying short-term outlook; the ability of energy networks to meet current output targets and to adapt successfully to the unprecedented changes affecting the industry, will depend on ensuring the right workforce with the right skills is in place.

The current skills crisis underscores the fact that the history of network regulation to date has been marked by a consistent failure to properly grapple with this issue: Ofgem needs to seriously rethink its approach, and part of that must entail putting concern for workforce pay on at least the same footing as concern for investor returns.

Health and Safety

Health and safety issues have not been given adequate attention in the price control framework to date, and the proposals for RIIO-2 appear to continue that trend. We know, based on evidence from the HSE and from our own members, that health and safety continues to be a significant issue in an industry which has a fatal accident rate that is roughly twice the national average.



In addition to relatively high levels of fatal accidents, we also know that ill-health, and especially stress and mental ill-health, are major problems for the industry. The Energy Networks Association (ENA) has acknowledged that rates of ill-health in the electricity industry are significantly above the average for the economy as a whole, while mental health issues are now the leading cause of lost work days in some network companies. We remain concerned that the way the price control has been designed to date has not taken adequate note of the health and safety implications of the targets Ofgem has set, and the way in which the framework of targets and outputs can contribute to creating a high-stress environment for workers, especially in a context where staffing levels are too low.

The HSE has also raised concerns that the potential erosion of levels of competency, resulting from underinvestment in workforce development and skills training, is posing risks to workplace safety. The HSE has been undertaking an investigation into the role of senior authorised persons (SAPs) in the energy networks following a spate of incidents in which highly stressful working conditions and ineffective management and auditing processes are believed to have resulted in serious safety breaches. The failure to take a much more robust and holistic approach to health and safety in the price control framework risks undermining efforts to make the industry a safer place to work.

A new approach to health and safety is especially important in the context of the major changes taking place across the industry. The development of 'smarter', more complex networks will bring with it new kinds of safety challenges, and we need to do much more 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 penalties.

As we have said before, we strongly believe that the way to improve safety in the industry and to prepare for the challenges of the future in RIIO-2 is to build health and safety into the price control framework in a much more comprehensive way. There are a number of specific steps we believe should be taken:

- A proper 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.
- An acceptable level of training and duration of mentoring for new staff, particularly within the installation of smart meters which require specialisms both in gas and electrical systems to be mastered, in order to prevent leaks and other mistakes occurring. This process can also result in the discovery of asbestos and other dangerous materials, especially whilst replacing meters in industrial settings.
- A specific allowance should be 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.
- A specific health and safety target that requires network companies to ensure that, as a minimum, rates of ill-health and accidents do not exceed the average rate across the economy as a whole, with further progressive targets put in place for continued reductions over time in days lost due to ill-health and accidents for each network company.

Ultimately, the industry record on health and safety is reflective of the way that the limited scope of the price control outputs to date has created a working environment that allows network companies to meet a set of narrowly-defined reliability targets without proper regard for the health and wellbeing of the energy workforce. The regulator has made little effort in the past to understand the impact of price control measures on the labour force and has assumed that if companies are meeting Ofgem targets then there is little cause for concern. This is an increasingly untenable stance to adopt, and must change.

As part of the move to reimagine the price controls in a more holistic way, we would like to see the safety output more broadly defined as a 'working standards' output that looks more extensively at labour standards and working practices. This should include a code of practice for both network companies and contractors, requiring them to comply with all relevant labour legislation, as well as health and safety regulations, ensure high levels of employee job satisfaction, meet targets for improving the diversity of the workforce, and adequately invest in workforce development and training. In this way, the historic failure of the price control regime to adequately assess the impact of output targets on the workforce could begin to be remedied, and the interests and well-being of workers protected in a context where greater financial controls are being considered.

Skills and Workforce Development

We remained deeply concerned that skills and workforce development issues have still not been addressed at all in the proposals for RIIO-2 to date. 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. It is therefore surprising and disappointing that Ofgem have not given this critical issue proper attention.

The scale of the skills and workforce development challenge faced by the energy industry is difficult to overstate. Roughly 1-in-5 workers in the electricity and gas utility sector are aged 55 or over, with an even higher proportion (25%) of older workers in engineering and skilled craft roles. As a result, the Energy and Utility Skills Partnership has forecast that 73,000 new hires will be needed just to replace retiring workers over the next decade. In addition, the rapidly changing energy landscape and the increasing skills demands placed on employers will require a further 20,000 hires, many in scarce STEM and skilled trades roles.

But, available evidence confirms that the industry is struggling to meet its skills needs. The utility sector has a rate of vacancies due to skill shortages that is significantly above the national average, while the current rate of vacancies per 100 workers in the electricity and gas sector is around 20% higher than across the economy as a whole. Key network roles, such as electrical engineers and overhead line workers, have been on the UK's critical shortage occupation list for many years, 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. A recent survey of utility executives found that 50% expect a skills crisis to erupt in the industry in the next 3-5 years, while more than 40% either don't have or are not sure if they have a robust workforce skills strategy in place ('Future of Utilities', Utility Week/Wipro, 2017).

Alongside this, the electricity and gas sectors face major challenges on equality and diversity issues. There are disproportionately low numbers of women and BAME workers in the sector, and the recent gender pay gap reports submitted by network employers highlight ongoing issues with the lack of women in engineering, managerial, and skilled craft roles, as well as possible equal pay breaches. Much more needs to be done to address this issue, especially as the failure to recruit and retain more women and BAME workers is only exacerbating skills shortages.

In this context, it is essential to ensure that adequate measures are taken to; a) ensure competitive remuneration packages, including good pension benefits in order to attract and retain skilled staff; b) provide funding for skills training and workforce development in order to adequately develop and upskill the existing workforce to meet new challenges; and c) address the significant 'diversity gap' in the industry, including recruitment, retaining, and adequately compensating more women and workers from BAME backgrounds.

Workforce Engagement

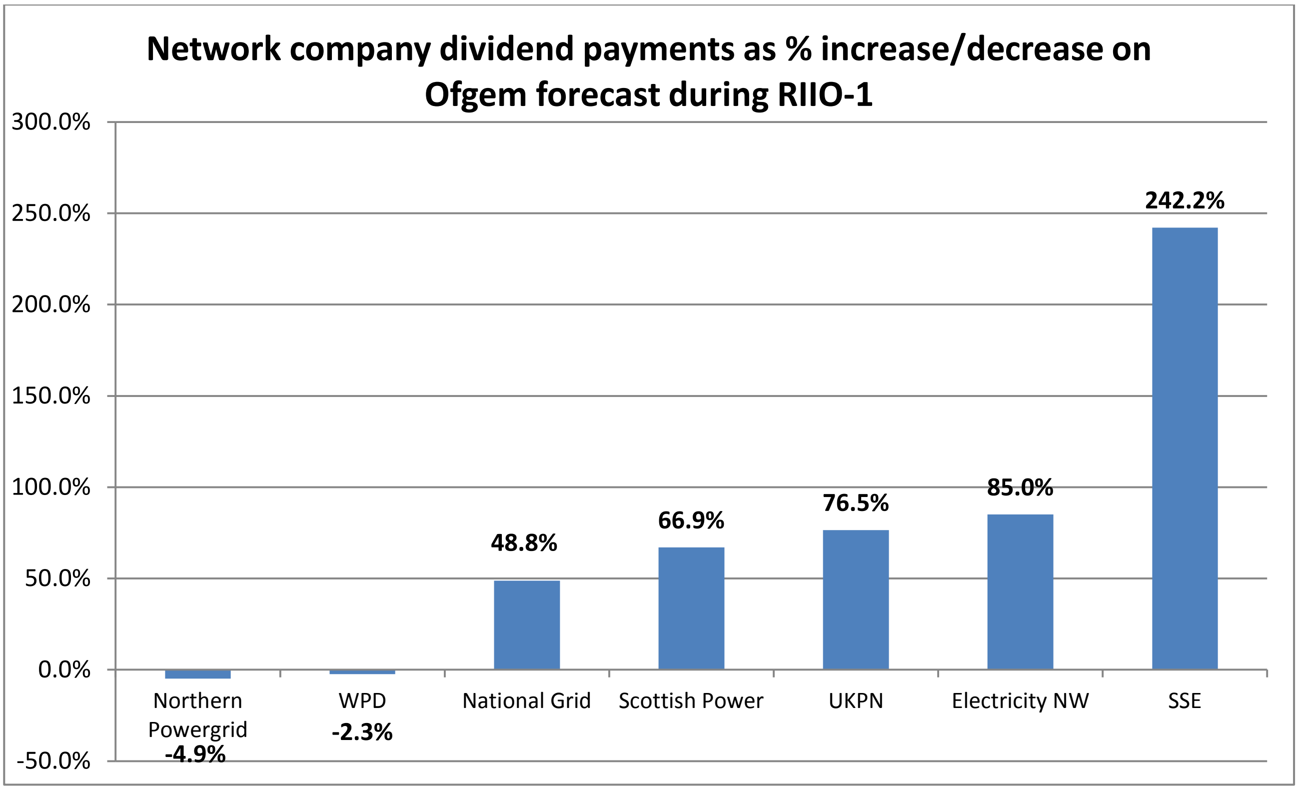
Whilst we welcome proposals to encourage greater engagement between companies and stakeholders, and to introduce mechanisms to provide greater oversight of company business plans, we are surprised and disappointed by the failure to make any mention of workforce engagement and consultation in the framework proposals. Given the obvious centrality of the workforce to delivering safe, affordable, and reliable networks, it is not at all clear to us why unions have been excluded from the stakeholder engagement proposals so far. We fully accept (and welcome) the inclusion of stronger consumer voices in the price control process, but there is a corresponding need to ensure workers have a strong voice in both developing and assessing company business plans, and in challenging the proposals put forward by Ofgem in response.

The stakeholder engagement proposals therefore need to be broadened to mandate the inclusion of worker representatives on the company-level engagement bodies, and similarly on the RIIO-2 Challenge Panel. This will help to ensure that the people responsible for operating the networks in accordance with the price control framework are actually given a proper voice in determining that framework.

Investor Returns

We welcome the recognition by Ofgem that the price control regime has privileged the interests of investors, and we are not opposed in principle to efforts to reign in excessive equity returns. However, we are concerned about the very real possibility that efforts to tighten up the price control regime could translate into reduced investment in the networks, curtailment of expenditure in vital areas such as training, innovation, and health and safety, and the further suppression of pay levels in order to preserve profits. We have already shown that real pay has been falling at network companies over the last decade, and further, unjustified pay austerity would deeply damage morale, harm recruitment and retention, and undermine efforts to prepare the workforce for the challenges ahead.

So far, the only unintended consequence of tightening up the financial regime that has been considered is the potential impact on financeability. A much more comprehensive assessment is needed of the wider impacts of attempting to restrict investor returns, and stringent measures need to be put in place to protect essential spending from corporate efforts to preserve investor returns. Some publicly listed network companies have dividend policies that increase annual payments to shareholders at least in line with RPI inflation and there is a very real possibility that maintaining such dividend growth will take precedence over other expenditure interests. We note that dividend payouts in the initial years of RIIO-1 have generally been much higher than Ofgem forecasts.



Competition

We are concerned by Ofgem's stated intention to try and increase competition during RIIO-2. We do not believe that competition is automatically an effective mechanism for ensuring safe, reliable, and cost-effective outcomes, especially in a sector characterised by the presence of natural monopolies. Despite Ofgem's claims to the contrary, the legacy of introducing competition via mechanisms such as the OFTO regime has not necessarily been positive. The House of Commons Public Accounts Committee (PAC) has been heavily critical of the OFTO regime for granting overly generous terms with minimal danger to investors, leaving consumers to assume the risks of these projects. PAC also noted that the OFTO market has been dominated by two or three consortiums of large investment firms, and the extent to which meaningful competition has actually been introduced into offshore transmission is very much 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 tends to lead to further fragmentation of network ownership and makes it harder to plan and coordinate network development efficiently and effectively. This contradicts Ofgem's stated principle that the networks should be managed as a whole system, and that new entrants should not be allowed to simply cherry-pick the most attractive work. We also note that in practice 'competition' is not reflected in choices available to end consumers who are tied to network operators and have no ability to impact service quality or costs by switching providers.

As we have seen recently with the collapse of Carillion and the debacle over the East Coast Mainline, the responsibilities and risks of meeting critical public needs, like secure supplies of electricity, will always lie ultimately with the government. Extending competition doesn't change that reality, and can in fact make it harder to plan for and properly manage risk. As a result, there is a pressing need to substitute an ideological drive for competition that is not necessarily supported by material evidence of improvement in service quality, safety, and reliability, with greater public management of critical national energy infrastructure to ensure our energy system is truly equipped to face the challenges ahead.

Conclusion

If the current regulatory regime is to have a future, it must be able to demonstrate that it is responsive to a much broader set of priorities and interests than in the past. As we have demonstrated, successive price control frameworks have delivered against a narrow set of reliability targets, and provided generous returns to shareholders, but at the expense of seriously eroding the pay and working conditions of network staff, whilst also leaving network companies poorly equipped to face future challenges. With public confidence in the energy industry at a particularly low ebb, and widespread mistrust of both energy companies and the system of regulation, Ofgem will need to demonstrate a willingness to work in a very different way and engage meaningfully with a much broader array of stakeholders than in the past.

The concrete issues we have raised here are of deep concern to our members, who comprise the tens of thousands of people who work hard every day to supply homes and businesses with energy. If the system of network regulation is to be genuinely just, it must begin to listen to their voices, as well as those of energy consumers, in a way that it has not done previously. We remain open to a meaningful discussion of ways that network regulation can better achieve that, and would welcome a discussion with Ofgem on how the issues we have raised here can be effectively incorporated into the price control framework.