



THE MONOPOLIES AND MERGERS COMMISSION

South of Scotland Electricity Board

A Report on the efficiency and costs
of the Board

*Presented to Parliament by the Secretary of State for Trade and Industry
by Command of Her Majesty
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as at 9 June 1986**

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*These members formed the group which was responsible for this report (see paragraph 2 of the Introduction).

Note by the Department of Trade and Industry

In accordance with sections 17(4) and 17(5) of the Competition Act 1980, the Secretary of State for Trade and Industry has excluded from the copies of the report as laid before Parliament, and as published, certain matters publication of which appears to the Secretary of State to be against the public interest or which are matters relating to the affairs of particular persons whose interests would, in his opinion, be seriously and prejudicially affected by publication and publication of which appears to him not to be in the public interest. Accordingly certain parts of the text, certain figures and one appendix have been omitted. The omissions are indicated by a note in square brackets.

No exclusions have been made from Chapter 13, Summary of conclusions.

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Introduction

1. On 7 October 1985 the Department of Trade and Industry sent to the Commission the following reference:

The Secretary of State, in exercise of his powers under section 11(1)(a) of the Competition Act 1980, hereby refers to the Monopolies and Mergers Commission ('the Commission') the questions set out below relating to the efficiency and costs of the South of Scotland Electricity Board ('the Board') in discharging its functions.

The Commission shall upon this reference investigate and report on the following questions—

- (1) whether in discharging its functions the Board could improve its efficiency and thereby reduce its costs, with particular reference to:
 - (a) the management of finance (including funding arrangements) and capital investment and the methods used to establish and monitor the Board's fixed and working capital requirements;
 - (b) the Board's arrangements, including pricing, for trade in electricity with the Central Electricity Generating Board and the scope for making changes in order to bring about a more efficient use of generating resources;
 - (c) the performance aims which affect the Board; and
- (2) whether, in relation to any matter falling within question (1) above, the Board is pursuing a course of conduct which operates against the public interest.

The Commission shall report upon this reference within a period of six months beginning on the date hereof.

(signed) M J Vile
An Assistant Secretary
Department of Trade and Industry

2. On 8 October 1985 the Chairman of the Commission, acting under section 11, sub-section (a) of the Competition Act 1980 and Part II of Schedule 3 of the Fair Trading Act 1973, directed that the functions of the Commission in relation to the reference should be discharged through a group of six members with Mr H Holman Hunt, a member of the group, as Chairman. The composition of the group, as then constituted, is indicated in the list of members which prefaces this report.

3. On 7 March 1986 it was announced that the Secretary of State for Trade and Industry was satisfied that there were special reasons why our report could not be made within the time specified in the reference. Accordingly he agreed that the reporting period for the reference should be extended to 4 July 1986.

Scope of the inquiry

4. An important part of the responsibilities of the South of Scotland Electricity Board is for planning and generating power. However, since 1966 these matters have, by agreement between the South Board and the North of

Scotland Hydro-Electric Board (the North Board), been considered under the terms of joint planning and generation arrangements. Thus any full inquiry into the South Board should relate their contribution to these joint arrangements. At the time of inquiry last year into the North Board, we decided to defer close examination of these arrangements. They have been included within the scope of the present inquiry.

Method of inquiry

5. On 7 October 1985 the Department of Trade and Industry published the terms of reference and invited persons wishing to give evidence to write to the Secretary of the Commission. Appropriate notices were placed in:

The Times

The Scotsman

The Glasgow Herald

The Electrical Times

The Electrical Review

6. We invited the CBI, the TUC and other bodies which might have an interest in the inquiry to submit evidence. We sought the views of the local authorities in the South Board's territory and of companies trading with the South Board. One hundred and thirty-three letters were sent to which we received 68 replies. Of these 38 had no comments, or expressed satisfaction with the South Board's supply and services. In addition a number of individual customers of the South Board submitted evidence. A summary of evidence received from other parties is provided in Annex 1 to this report.

7. The South Board provided much written material at our request and attended two hearings. Members of the Commission visited the South Board's Head Office in Glasgow. They also visited the Hunterston and Torness power stations, the Grid Control Centre at Kirkintilloch and the Central and South West Scotland Area headquarters at Hamilton. During these visits, they met members of the Board and its staff, as well as the local trade unions representatives. In the course of the inquiry the Commission's officials visited offices and installations in the South Board's territory.

8. The Central Electricity Generating Board submitted material relating to paragraph 1(b) of the above terms of reference and attended two hearings. The National Coal Board submitted written evidence relating to the supply of coal.

9. The appropriate trade unions attended two hearings with the Commission in London.

10. Some of the evidence obtained in the course of our inquiry was of a confidential nature and our report contains only such information as we consider necessary for an understanding of our conclusions.

11. A glossary of terms and abbreviations is provided at the front of this report. We have used the term 'South Board' when referring to the South of Scotland Electricity Board as an organisation and the term 'the Board' when referring to the Chairman, Deputy Chairman and part-time members sitting as a Board (but we have also used 'the Board' as an abbreviation for 'the South Board' where its meaning is clear in the context).

12. We should like to take this opportunity of thanking all those who helped us in the inquiry. We are particularly grateful to the representatives of the South Board on whom the main burden of the inquiry fell.

CHAPTER I

General assessment

1.1. Our terms of reference require us to report whether in discharging its functions the South Board could improve its efficiency and thereby reduce its costs, with particular reference to its financial management, its trading arrangements with the Central Electricity Generating Board (CEGB) and the performance aims that affect it. Then we are asked whether in relation to any matter falling within this question the South Board is pursuing a course of conduct which operates against the public interest.

1.2. Our review of costs and efficiency covers all the main activities of the organisation with financial management, trading with the CEGB and performance aims discussed in Chapters 5, 10 and 4 respectively. Our conclusions are set out in full at the end of each chapter. Not all of these suggest action. Points which require action are summarised in Chapter 13. A number of bodies made submissions to us, and these are summarised in Annex 1, together, where appropriate, with the South Board's comments on them. The main issues raised by these submissions have been covered in the appropriate parts of the report, although we have not addressed each point in detail.

Background

1.3. Like the North Board on which we have reported¹, the South Board is responsible for generating as well as transmission, distribution and sales of electricity in its territory. Its activities cover the whole spectrum of generation—coal, oil and nuclear as well as small amounts of hydro and gas turbine. Over 70 per cent of the capacity of the Scottish system lies within the South Board's territory, and it is responsible for scheduling all Scottish plant according to a single merit order.

1.4. The Scottish system has a substantial level of surplus capacity, the legacy of investment decisions taken in many instances more than a decade ago on demand forecasts which in the event have not been realised. We have therefore taken the existing capacity as given and focused our investigation on how this surplus is managed (Chapter 8). The Scottish power stations are, with one or two exceptions, modern and efficient, with many years' potential use ahead of them, and they consist mainly of a small number of large generating units (over 600 MW). The gains from mothballing or closures are more limited than might appear. Moreover in the last two or three years the Scottish system has derived great benefits from the flexibility which a mix of surplus capacity offers, for example, during the miners' strike of 1984–85, and more recently as a means of responding to the changes wrought by the fall in energy prices. The surplus also has important implications for tariff policy (Chapter 11).

1.5. Our inquiry took place against the background of the investigation by the House of Commons Select Committee on the Environment into nuclear

¹ The North of Scotland Hydro-Electric Board (Command 9628).

waste and, during its later stages, of the disaster at the Chernobyl nuclear power station. The Layfield Committee inquiry into Sizewell 'B' which heard a lot of evidence about nuclear safety has not yet reported. Therefore we have not attempted to cover this aspect of the South Board's activities.

Joint generating arrangements

1.6. The Scottish system is operated as a single merit order of generating plant. It is managed and financed according to joint arrangements agreed in 1966 between the two Scottish Boards. In our report on the North Board we said that we would leave consideration of these arrangements to this report, by which time we would have been able to examine the performance of both Boards individually and as partners in these arrangements. We discuss the operation of the joint system in Chapter 7 and its financing through the joint generating account in Chapter 5.

1.7. The arrangements are unusual and give rise to some organisational anomalies. The North Board's special expertise is used for the detailed scheduling of its own hydro-electric stations within the South Board's system for the overall scheduling of Scottish electricity generation. The South Board's hydro-electric plant is separately managed within the same overall system, and different control arrangements are applied to the North Board's two pumped storage stations. Each Board is separately responsible for the maintenance of its own plant, but the timing of maintenance work has to be jointly planned. Actions by one Board can thus affect the costs incurred by the other, and the rules by which pooled costs are subsequently allocated are necessarily judgmental. The responsibility for the management of generation is thus divided in a complex manner which is bound to result in some dilution of accountability. The implementation of these arrangements therefore demands of the two Boards a high degree of co-operation, a complete understanding of each other's responsibilities, and good communication between them at all levels. Despite the anomalies the arrangements are effective and appropriate to the existing two-Board structure of electricity supply in Scotland. So long as collaboration between the two Boards remains as close as it is, the joint arrangements should give no cause for concern. Any possible disadvantages are far outweighed by the gains in efficiency, and consequent benefits to consumers in Scotland as a whole, derived from operating the Scottish generating system as one.

Performance

1.8. The South Board is a well run organisation. It manages its core function, the generation, transmission and distribution of electricity, efficiently and skilfully. Management at all levels devotes considerable time and effort to keeping costs down. Since 1980 the Board's capital expenditure and the energies of much of its most senior management have been dominated by one project, the construction to time and cost of the 1300 MW nuclear power station at Torness.

1.9. We were impressed by the high calibre of management, particularly of the senior staff whom we met. The concentration of strategic decision-making in the hands of the Chairman, Deputy Chairman and the two Directors, and the generally tight control over the business exercised by Head Office, is well

suited to an organisation whose electricity is produced from a small number of large generating units, and the bulk of whose consumers live within a narrowly confined geographical area. The Board sets itself high standards of technical and managerial efficiency and competence, and monitors achievement against them. In the management of its main operations we believe that these standards have been met.

1.10. However, we have detected some areas where the Board's performance has not matched these exacting standards. These are: billing and debt collection, surpluses of manpower and appliance sales. They give rise to difficult problems of long standing and of considerable sensitivity with respect to the Board's industrial relations or relations with its consumers. The Board has proposals for resolving them which have been, or are about to be, implemented. Generally we do not quarrel with the proposals as such. They seem to us to be sound, and in any case it will take time before any judgment can be made on their effectiveness. Rather our concern is that these are areas to which the highest levels of management ought to have devoted more time and adopted the same rigorous approach that they have towards planning and building Torness and, most recently, towards pressing for a better deal on fuel purchases in the wake of the fall in the price of oil.

The reference questions

Financial management

1.11. The South Board's finances are soundly run. It has well constructed financial management systems which present an accurate picture of its financial position to decision-makers at all levels. It has a cost reduction programme and an effective audit committee. Useful initiatives such as the introduction of priority based budgeting have improved performance. However, in the last five years there have been substantial variances from these budgets, notably a tendency to underspend on capital budget. Many of these relate to expenditure on building Torness where the spread of payments has not surprisingly been uneven, and we found the Board's explanations of these variances reasonable.

1.12. One area of financial management which gives us cause for concern is the large and increasing amount of debt arising from late or non-payment of consumers' bills. Over the years the Board has been subject to pressures from many quarters, including pressure from the consumer councils and other bodies using the Code of Practice, not to act too harshly in an area of consistently high unemployment and social deprivation. It has at last come up with a package of measures to deal with this problem, but we think that it might have tried to remedy matters rather earlier than it has.

Trading with the CEGB

1.13. The present system of exchanges of electric power between Scotland and England on the basis of differences in marginal costs between the two Boards and the sharing of benefits between them is necessarily complicated. We have explained it in some detail therefore in Chapter 10. It is quite different from the 'arms length' arrangements provided for in the CEGB's agreement with Électricité de France, but the circumstances are also different. Differences in generation costs between England and Scotland are comparatively small.

We believe that trading between Scotland and the CEGB on this basis brings greater benefits to consumers in both areas than would be obtainable from an arms length arrangement. The success of this method of trading increases with the growth in each Board's confidence in the integrity of the other's costing. The Boards plan to make this trade more efficient by bringing it within the ambit of the CEGB's scheduling program. We have not suggested any changes to the principles governing this trading, but have indicated some ways in which further improvement might be made.

1.14. Given the surplus capacity in the Scottish system we have considered the prospects for longer-term agreements either specifying levels of energy to be exchanged, or committing a specified segment of Scottish capacity to the CEGB. We have not found evidence that such agreements would give significant advantages over the present arrangements. We could imagine circumstances in the future (especially when Torness is fully operational and the CEGB may be looking for extra capacity) in which both sides would benefit from a longer-term arrangement as a supplement to day-to-day trading. Both Boards should be fully alert to such possibilities as do occur.

Performance aims

1.15. We discuss the South Board's performance against its aims in Chapter 5. Like the North Board it met its targets despite the considerable extra costs it incurred in burning oil for its own requirements and for sale to the CEGB during the miners' strike of 1984-85.

1.16. The two Boards are currently discussing with the Scottish Office new performance aims to run from the beginning of the next financial year (April 1987). The Scottish Office suggested that we might make some more general comments on the appropriateness of the present performance aims which they and the South Board consider in some ways unsatisfactory. We do so in Chapter 4.

1.17. The Government¹ prescribed performance aims for the nationalised industries with the objective of focusing attention on increasing efficiency as well as controlling costs. There is a distinction between performance aims and performance indicators. The latter provide a measure of the efficiency of various aspects of the business. Performance aims are cost reduction targets which should cause the Board's budgets to be set more tightly than would otherwise have been the case. The closer that the aims can be integrated with the Board's financial and budgetary systems the easier it will be to use them to ensure that budgets are tight. The present performance aims suffer from being too complicated. They are set in terms of reductions in what are termed controllable unit costs. In seeking, by way of exclusion or the use of deflators, to correct for those elements of cost deemed to be beyond the Board's control the aims have become distorted and unclear. A performance aim should be a simple cost reduction target which does not attempt to make allowance in advance for external influences. We recognise that in practice some form of correction will be needed to take account of inflation and, given their importance and volatility, fuel prices. But such corrections should be kept to an absolute

¹ White Paper on the Nationalised Industries (Cmnd 7131) paragraphs 76 to 78.

minimum. We would urge the Scottish Office and the two Boards in framing new performance aims to resist the temptation to correct for more than these two factors. Performance indicators provide the means of judging efficiency independently of external influences. For reasons of public accountability, we would like the Boards to continue to publish these indicators in their Annual Reports.

Other topics

Manpower and industrial relations

1.18. We discuss manpower policies in Chapter 6. The South Board devotes a great deal of time and effort to maintaining good industrial relations. We commend it for having identified significant reductions in manpower needs [*Details omitted. See note on page iv.*

] We [*Details Omitted. See note on page iv.*

] recommend strengthening the Chief Personnel Officer's role to co-ordinate the further measures that will be required. We also believe that, given the difficulty and delicacy of the operation, any scheme will require supervision by the highest levels of management to ensure that the right decisions are taken and that they are implemented with skill.

Fuel purchasing

1.19. Fuel accounts for some 40 per cent of the South Board's total costs. The greatest single contribution which the Board can make towards reducing them is to keep the prices it pays for its various fuels down. In negotiating with its suppliers it has to strike a balance between the advantages of obtaining its supplies at minimum cost and its interest in the security of these supplies through the continued availability of indigenous sources of fuel. Such a policy has social implications, but these lie beyond the Board's own responsibility. The South Board's surplus capacity gives it scope for switching between coal- and oil-fired generation. This year's sharp fall in oil prices has strengthened its bargaining position with its fuel suppliers. Our recommendations are designed to support it in its efforts to exploit this, both to obtain better terms from its suppliers and to use oil where this is feasible and economic. We would like to see the price of coal purchased by the South Board moving more closely into line with the longer-term costs of obtaining coal from sources other than from the National Coal Board—which include private suppliers as well as imports.

Tariffs

1.20. The South Board's approach to setting tariffs is based essentially on accounting costs despite some movement towards reflecting costs at the margin. Given the surplus in the Scottish system we think that the Board could go further than it has towards meeting the objective set by the Secretary of State for Scotland (Appendix 4.1 paragraph 4), without violating its financial obligations to the Government. There is scope for profitably selling more electricity by offering some of the surplus at rates more closely reflecting the incremental cost of generating it. In Chapter 11 we make some suggestions as to how this might be achieved.

Shops and related activities

1.21. The sale and servicing of electrical appliances is a marginal activity in which the Board recognises that it has been unsuccessful. After many years of losses it is only now moving into profit following the introduction of a series of measures which include an in-house customer credit scheme. The Board's justification for retaining its shops despite the losses they were making is that they play an important role in customer service and consumer relations (a view endorsed by the Consumers' Council). We do question, however, whether shops are the only acceptable means of providing this service, and think that if the present measures do not result in sustained profitability the Board should consider more seriously than it has done whether it is sensible to maintain shops at all.

Priorities for action

1.22. In the conclusions to each chapter of our report we make a number of suggestions for improvement, and these are summarised in Chapter 13 in the order in which they occur. We specify five areas which we believe should have priority in the Board's thinking, and which should have the full attention of its most senior managers. These are:

- (a) a continued drive to reduce dependence on high-cost NCB coal and to purchase whatever fuels offer an appropriate combination of economy and security of supply;
- (b) a better co-ordinated effort towards realising the cost savings from the reduction in its manpower needs which the Board has identified;
- (c) close monitoring of the present measures to reduce consumer debt and the consideration of alternative measures should the present ones show signs of being ineffective;
- (d) development of a system for setting tariffs in a way which more closely reflects marginal costs and a tariff structure which will bring more of its surplus capacity into economic use; and
- (e) reconsideration of the future of appliance sales and servicing if the present strategy does not produce the sustained profitability which is anticipated.

The public interest

1.23. We have already said that the South Board is a well run organisation. In the course of our inquiry its managers have given us plentiful examples of competence, imagination and flair. We give it high marks for performance in generating electricity and distribution and for the way in which it conducts its relations with its consumers. It has set itself tight targets for reducing costs and improving its efficiency which generally it has lived up to. We have not devoted much space in our report to generation, to management structure or to management information systems because we found these to be satisfactory. Apart from the topics we were specifically charged to investigate—financial management, trading with the CEGB and performance aims—we have concentrated either on those such as fuel prices where new circumstances (including the fall in oil prices) offer new opportunities to exploit, or on those areas where we consider that the Board's performance falls or has fallen short of its own

high standards. Our concern now is that with the construction of Torness reaching completion, the highest levels of management should devote more of their energies towards these areas of relative weakness. In some cases measures to resolve the problems are in train. These will require careful monitoring by senior management and a commitment to seeking more radical solutions if the present measures show signs of being ineffective.

1.24. We do not consider that in respect of any of the matters we have investigated the South Board is pursuing a course of conduct which operates against the public interest.

A