

Performance aims

Introduction

4.1. At the request of the Scottish Office we have given particular attention in our inquiry to the appropriateness and effectiveness of the South Board's performance aims. In this chapter we discuss that topic in the context of the full range of the Board's financial obligations and objectives. The Board's performance against its financial objectives and aims is discussed in Chapter 5.

The framework of financial objectives

4.2. The South Board's statutory financial obligation is presently set out in the Electricity (Scotland) Act 1979 which requires the two Scottish Boards to 'secure that their respective revenues are not less than sufficient to meet their outgoings properly chargeable to revenue account taking one year with another'.

4.3. In addition to its statutory obligation the South Board is subject to the monitoring and control arrangements set out in the 1978 White Paper on the nationalised industries¹ as amended by changes announced by the Government from time to time. The objectives for the two Scottish Boards, which were published by the Secretary of State for Scotland on 12 May 1983, are set out in full in Appendix 4.1.

4.4. The financial obligations presently laid on or agreed with the South Board by the Secretary of State for Scotland comprise:

- (a) an external financing limit for the Board set in the autumn of each year for the following fiscal year;
- (b) a financial target for the Scottish Electricity Boards to achieve jointly an average annual return over the three years to 1985-86 of 1.75 per cent on average net assets valued on a current cost basis;
- (c) a performance aim for the controllable generation and transmission costs per unit of electricity sent out by the Scottish Electricity Boards jointly to be reduced, compared with the base year 1982-83, by 4 per cent in real terms by 1984-85 and maintained at the reduced level in 1985-86 (see also paragraph 5.6); and
- (d) a performance aim for the South Board to reduce controllable distribution and other costs by 8 per cent in real terms per unit of electricity sold by 1985-86, compared with 1982-83.

4.5. In addition to the financial obligations set out in paragraph 4.4, the Board's capital expenditure programme is subject to approval by the Secretary of State for Scotland.

¹ The Nationalised Industries (Cmnd 7131).

Controls upon capital expenditure and borrowing

4.6. The South Board's capital expenditure plans and its estimated requirements for external finance form part of its annual Investment and Financing Review. After modifications in the course of discussions with the Scottish Office, they become the basis of capital allocations and external financing limits for each of the following three years which are approved by the Secretary of State for Scotland. The capital allocation and the external financing limit for the first year become part of the Government's Public Expenditure White Paper for that year. In the course of that year, expenditure and borrowing are monitored and the capital allocation or the borrowing limit for the year can, subject to the approval of the Secretary of State, be amended. The allocations and limits which had been made for the following year may also be varied in the course of the next annual review.

4.7. The Board explained to us the concern, which it shares with other nationalised industries, that this system of control impedes efficient business planning by forcing the postponement or abandonment of investment opportunities for reasons unconnected with their commercial attractiveness. It raises special difficulties for those industries, such as the electricity supply industry, in which large capital projects have to be planned and carried out over long periods. The progress of the Torness power station project, which at present dominates the Board's capital expenditure programme, had not been affected, but one result had been that relatively small departures from planned expenditure on that project (resulting, for example, from changes in the timing of the submission of bills by contractors) had a disproportionate impact upon the remainder of the programme. The programme for the refurbishment of the distribution system was cited as an example of work which had been postponed as a result of the Government's control upon the Board's capital expenditure.

The setting of financial targets and performance aims

4.8. Although the final responsibility for the setting of financial targets and performance aims rests with the Secretary of State for Scotland, the numerical targets which are chosen are the outcome of a process in which the South Board itself necessarily plays an important part. The Board's own projections, as derived from its planning and budgetary activities and set out in its Investment and Financing Review, are the starting point of the process. The Board's senior management accept that it is for them to propose targets and aims which are demanding but realistic. They see the setting of such targets and aims as being wholly consistent with the Board's strategy of seeking a progressive reduction of tariffs in real terms. They consider it important, however, that the targets and aims should be integrated with the Board's internal budgets.

The form of the performance aims

4.9. We examined the rationale for the use of a joint performance aim for generation and transmission costs, and for the adjustments which are at present required to calculate the Board's controllable costs.

4.10. The formulation of a performance aim in terms of the combined costs of the two Scottish Boards means that the required cost reduction has to be

separately allocated before it can be related to the budgets of either Board. The Boards put it to us that, since the generation of electricity in Scotland is managed as a single system, its operating costs could fall on the individual boards in proportions which could not always be predicted with confidence. Also, since some 70 per cent of Scottish electricity is presently generated in the South Board's area, relatively small variations in its output could have a disproportionate effect upon the output required of and the cost per unit generated by the North Board. For these reasons both Boards saw no alternative to a joint aim. Its implications for each Board should, in their view, be for them to determine, and to adjust as circumstances required.

4.11. It was explained to us by the Scottish Office that in formulating the present definition of 'controllable costs' for the purpose of performance aims, considerable attention had, at the time, been given to the exclusion of factors thought to be wholly or largely outside the industry's control. The factors which had been considered important in this respect had been:

- (a) the cost of fuel, which accounts for over 70 per cent of the South Board's operating costs of generation and transmission;
- (b) interest charges, which account for some 25 per cent of the South Board's total costs;
- (c) local authority rates, which account for some 8 per cent of generation and transmission costs and of which a major proportion is related not to occupancy but to output;¹ and
- (d) weather conditions, of which temperature is a major influence upon the demand for electricity, and rainfall a major influence upon the supply of electricity from hydro-electric plant.

4.12. The main adjustments which it had been decided to make to the Board's costs to exclude these factors and to express controllable costs in real terms were:

- (a) the correction of fuel costs to base year prices using a complex index related to the fuels used and the actual prices paid;
- (b) the exclusion of local authority rates, of interest and depreciation charges and of the effects of trading with the CEGB;
- (c) the weather correction of units sent out, the correction of hydro-electric output to an average level for joint generation and transmission costs and for the North Board's distribution and other costs; and
- (d) the deflation of salary and related costs using an index of the average earnings of the Board's employees, and the deflation of other costs using the Retail Prices Index.

4.13. In the light of experience, the South Board now regards these adjustments (and the fuel cost adjustment in particular) as excessively complicated, making the performance aim for generation and transmission costs difficult to understand and relate to internal budgets. In negotiating future

¹ Rateable values for assets used for the generation, transmission and distribution of electricity are based upon the output and sales of electricity. Rates paid on these assets account for over 90 per cent of total rates paid.

performance aims it intends to seek a considerable measure of simplification. It nevertheless sees a continuing need for a fuel price adjustment, on the grounds that otherwise the setting of a performance aim would mean trying to predict fuel price movements; and that, once set, the figure chosen could have an undesirable influence on fuel price negotiations. It favours a simplified method of correcting fuel costs to base-year prices, using actual prices paid rather than attempting to devise an external index of world fuel prices.

4.14. The South Board considers it important that performance aims should continue to be set for periods of three years or more in order to reduce the influence of the year-to-year cost fluctuations which are characteristic of the electricity supply industry. Provided that these conditions are met and that a joint cost-reduction aim is maintained for Scottish electricity generation and transmission, it sees less need for other adjustments.

Performance indicators

4.15. In its annual report and accounts, the South Board publishes charts showing trends over the previous nine years of the following performance indicators:

- (a) million kWh sold per distribution employee;
- (b) million kWh sent out per generation employee;
- (c) thermal efficiency of coal- and oil-fired stations;
- (d) availability of large generating units;
- (e) average time without supply per consumer;
- (f) total cost of energy per kWh sold (at constant prices);
- (g) delivered cost of fuel per kWh sent out (at constant prices);
- (h) added costs per kWh sold (at constant prices);
- (i) distribution added costs per kWh sold (at constant prices);
- (j) generation added costs per kWh sent out (at constant prices).

The South Board told us that it regards these performance indicators as being a matter for its own management and that it does not consider it appropriate that they should be incorporated into the performance aims agreed with the Government.

Monitoring by the Industry Department for Scotland

4.16. In addition to documentation relating to the annual Investment and Financing Review, the South Board provides regular returns to the Industry Department for Scotland which fall into three categories:

- (a) statistical returns for use by the Central Statistical Office and by the Department of Energy;
- (b) financial returns, relating mainly to capital expenditure and borrowing, under the Treasury's procedure for the financial monitoring of nationalised industries; and
- (c) returns to augment the above material for the purposes of the Industry Department's own monitoring activities.

The Industry Department has explained to us that it regards the material which

it receives in the third category as necessary to give it a broad understanding of factors bearing upon the South Board's performance against its various obligations and objectives. The South Board questions whether much of this material serves a useful purpose. There have been discussions about the possibility of providing this material in the form of existing documents prepared for use by the Board's management.

Conclusions

4.17. The performance aims which apply to the South Board are at best a poor substitute for the incentives which act upon private sector organisations which are fully exposed to commercial competition. They cannot be effective unless they are set at demanding levels, taking account of benefits from past investment and from technological progress, and of comparisons with what is being achieved by other public sector and private sector organisations. Although set by the Government, they are the outcome of negotiations to which the Board itself is a party. In view of the greater expertise which it brings to such negotiations, the Board should, as a matter of public duty, accept the onus of demonstrating that its future performance aims satisfy these criteria (paragraph 4.8).

4.18. The performance aims which at present affect the South Board specify reductions in its real costs per unit of output. We have examined alternative specifications but we do not wish to suggest a change in this respect. The alternative of specifying a reduction in tariffs would reflect performance only when taken together with the financial targets. This is a complication which could cause confusion and unnecessary intervention.

4.19. The South Board's performance aims should be seen as the apex of its hierarchy of budgets and should exert a tightening influence upon them. Performance aims and budgets should be framed in terms which make their interaction readily apparent.

4.20. Because the generation of electricity in Scotland is managed as a single system, it should be subject to a single performance aim. For their other activities the two Scottish Boards should have separate performance aims (paragraph 4.10).

4.21. The controllable costs in the present performance aims incorporate adjustments intended to remove the influence of changes thought to be wholly or partly outside of the Board's control. Few of these changes are entirely beyond its power to influence. We think that future performance aims should encourage the Board to make appropriate policy responses to such changes. Where externally imposed cost increases are unavoidable, the Board should, like other organisations, be expected to seek compensating changes and efficiency increases elsewhere. For these reasons, adjustments to the Board's costs should be avoided in formulating performance aims (paragraphs 4.11 to 4.13).

4.22. The South Board and the Scottish Office have argued, however, that in view of the volatility of fuel prices and of their strong influence upon

generating costs, a deflator should be used to adjust the Board's fuel costs to base-year prices. We accept that there may be a case for such an adjustment in this special case (paragraph 4.13).

4.23. The deflator used for this purpose should, like that used to express the Board's costs in real terms, be based upon an index of external prices and not upon an index of prices paid by the Board.

4.24. In order to spread the impact of other external influences upon the Board's costs, performance aims should continue to be set for periods of at least three years (paragraph 4.14).

4.25. Performance indicators are a valuable adjunct to performance aims. They can be used to monitor the efficiency of various aspects of the Board's business, even in the face of externally imposed changes in the costs of some activities (paragraph 4.15).

4.26. Performance indicators should continue to include measures of the quality of the service which the Board provides to its customers, so that this aspect of performance can be monitored in conjunction with reductions in unit costs.

4.27. In the interests of public accountability the Board should continue to publish the range of performance indicators which is set out in its present annual report. Consideration should be given to extending the range of indicators provided.