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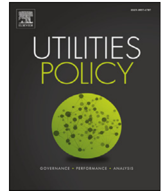

A perspective on the rise and fall of the energy regulator in Britain

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ABSTRACT

The process of Electricity Market Reform instigated in 2010 is leading to fundamental reforms to the UK electricity market. Despite its previous strong presence in the policy process, the British energy market regulator, OFGEM, appears to have only a minimal role in the implementation of these reforms. This article reviews the history of OFGEM, including expectations for the agency when it was established and how it evolved over time. From this perspective, several factors that might have contributed to OFGEM's apparent marginalisation are identified. These include perceptions of a poor track record, a tendency of governments to bypass the regulator for decisions deemed important, and the subordination of economic issues to climate-change priorities.

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1. Introduction

In the 1980s, when the British programme of introducing privatisation and competition to public services like telecommunications, natural gas, and electricity was implemented, it was believed that regulation could be 'light-handed' in form and function, and would only be required temporarily until competition took hold (Beesley and Littlechild, 1983). Fifteen years later, around 2000, the regulator, the Office of Gas and Electricity Markets (OFGEM), was at the centre of British energy policy. It managed the redesign of energy wholesale markets and the introduction of retail competition for small consumers, and contributed to far-reaching decisions on industry structure, including mergers and take-overs. It seemed clear that the vision of light-handed and temporary regulation was illusive. Setting monopoly prices was an on-going task, required much more effort than had been anticipated and market oversight, which originally was not expected to require significant input, took up a large proportion of the agency's budget. In 2003, OFGEM split its workload into four parts, with 'making markets work effectively' the largest element, accounting for 57 per cent of its budget, and 'regulating monopoly businesses intelligently' accounting for most (28 per cent) of the rest (OFGEM, 2003).

Another 15 years on (by 2015), however, a major rethink of the energy market design was underway with little input from the agency, and OFGEM appears to have become ineffective and marginalised. In theory, the redesign of the wholesale markets and the introduction of retail competition should have been one-off events that once completed, would reduce the regulatory workload. But paradoxically, while its influence on policy appears to have waned, regulatory activity appears to have grown; OFGEM's budget in 2014 had more than doubled and its head-count nearly tripled from 10 years before. The 2014/15 annual report (OFGEM, 2015) does not break down its budget among activities in the way it did in 2003, but market monitoring remains clearly a major concern.

This article reviews key decisions affecting energy markets since the mid-1980s, including those regarding the role of the UK energy regulator. The regulatory role has been heavily influenced by the attempt to create competitive wholesale and retail markets and thus much of the history of regulation is the history of attempting to introduce competition. This historical perspective informs the answers to three key questions: First, has OFGEM been ineffective or are its apparent failings the result of intrinsic difficulties in introducing markets? Second, why has OFGEM been marginalised and its scope narrowed at the same time as its level of activity has grown? And third, is this history a particular one for Britain alone or is it an experience that will be replicated in other countries?

2. The original view of regulation: 1983–90

When utility regulation was first being discussed in Britain, there was a determination that the system introduced would be very different from that implemented in the USA, which was seen

Abbreviations: OFGEM, Office of Gas and Electricity Markets; OFFER, Office of Electricity Regulation; OFGAS, Office of Gas Supply; EMR, Electricity Market Reform.

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as intrusive, slow, and costly. For the UK, from the beginning, the regulator would set monopoly prices but also manage the transition to a fully competitive industry, at which point the regulator would no longer be needed. The role would be quasi-judicial, with government setting policy and the regulator interpreting and implementing it.

A way to avoid the perceived bureaucracy and heavy hand of the US system (known as "rate-of-return regulation") was provided in a report commissioned by the UK Secretary of State for Industry from Professor Stephen Littlechild entitled 'Regulation of British Telecommunications' Profitability and published in February 1983.[1] The assumption behind the report was that regulation need only be a temporary requirement and the regulator's job was simply to 'hold the fort' (Beesley and Littlechild, 1989, p. 471) until competition arrived. This report was especially famous for its proposal to regulate monopoly prices using the 'RPI-X' incentive formula and it was this formula on which the hopes for 'light-handed' regulation were mainly based. Under the formula, monopoly prices would be allowed to increase by the rate of inflation, Retail Price Index (RPI), minus the 'X' factor. Effectively, this was meant to require that regulated companies would have to improve their efficiency by X percent per year. If they did not, their profits would fall. How they achieved this, whether through capital investment or operating cost savings, was of no concern to the regulator as long as service standards were maintained. If they could beat their target, they were able to keep the additional income; this was the embedded performance incentive. The assumption was that X would always be a positive number, so consumers could expect real prices for regulated activities to decline as markets were 'liberalised' and competition took hold.

The X factor was to be set once only and this initial X was expected to apply until competition took over. Beesley and Littlechild (1983, p. 20) said: 'The level of X would, in practice, be the outcome of bargaining between [the utility] and the Government; an exhaustive costing exercise is not called for'. RPI-X was regarded as appropriate only because competition was expected to arrive (Beesley and Littlechild (1983, p 20).

This model of regulation was first applied to the telecommunications industry, with the creation of the Office of Telecommunications (OFTEL) in 1984, and applied to the gas industry in 1986 through the Office of Gas Supply (OFGAS), to the electricity industry in 1989 through the Office of Electricity Regulation (OFFER), and to the water industry in 1989 through the Office of Water Services (OFWAT).[2] In 1998, the two energy regulators were merged to become the Office of Gas and Electricity Markets (OFGEM). In 2003, the duties of OFTEL were passed to the Office of Communications (OFCOM), in conjunction with the merger of the British telecommunication and broadcasting regulators. At that point, prices ceased to be regulated and OFCOM's duties became purely the overseeing of competition, arguably, in this case, fulfilling the vision that regulation could be temporary.

Within the Government, perhaps reflecting Margaret Thatcher's desire for strong central leadership, regulatory decision-making was in the hands of a single person, the Director General of the Regulatory Office. To summarise, the initial and guiding vision for UK regulation was that it would be a temporary, 'light' requirement, subordinate to the main influence of unencumbered free markets.

3. The transition period: 1990–1997

In 1989, Professor Littlechild was appointed as the first Director General of Electricity Supplies (DGES), a year ahead of the privatisation of the industry. By then, the competitive energy model had emerged, originally employed in Chile and subsequently in UK, in a form subsequently copied around the world (Thomas, 2006a). The model was comprised of wholesale markets for gas and electricity, retail competition for all consumers, and separation or 'unbundling' of the monopoly networks for transmission and distribution from the competitive production activities. The rationale for unbundling was that networks should essentially be open to everyone on the same terms and this was most likely to be achieved if the network owners were not allowed to own competitive activities, which would give them an incentive to price discriminate or give favourable access terms.

3.1. The gas industry

The introduction of competition to the gas and electricity sectors was hampered by the failure to implement this ideal structure (Thomas, 2003). For the gas industry, a nationally owned company, British Gas, was privatised intact with no attempt to 'unbundle' its networks or break up its *de facto* wholesale and retail monopoly. It was hoped competition would come through new entrants. The budget for OFGAS in 1987–88, the first year in which the organisation was fully active, was £1.35 m and the agency employed 21 people. James McKinnon, the Director General of Gas Supplies (DGGS), then expected that a staff of 30 would be sufficient. McKinnon later acknowledged that it took more than two years for OFGAS to have the capacity and skills to begin to regulate British Gas effectively (OFGAS, 1991).

In 1990, a complaint by a large gas consumer led to an investigation by the competition authorities, the Office of Fair Trading (OFT) and the Monopolies and Mergers Commission (MMC) (Thomas, 2003). This led to far-reaching proposals to break British Gas's hold on the wholesale market, to guarantee non-discriminatory access to the networks, remove any discriminatory pricing policies between different consumer classes, and require the re-setting of the X factor every 5 years. In 1992, a review of the gas market by the OFT led to a complete change in the way monopoly prices were set, introducing what was fundamentally an *ex ante* form of rate-of-return regulation. This change was subsequently applied to the electricity industry. A few years before the X factor was due to be re-set, the network company was required to submit its investment plan to the regulator for five years over which the next X factor would apply. There was then a long negotiation period with the regulator in which the regulator decided which capital investments would be allowed. Prices would be set to ensure funding and a 'reasonable' rate of return on this investment. In other words, while the results continued to be presented as an X factor, the mechanism was a form of rate-of-return regulation that necessitated an 'exhaustive costing exercise'.

The effective monopsony power British Gas had over purchase from the UK's North Sea gas fields, which at that time effectively provided the UK with all its gas, was progressively broken through regulatory requirements and retail competition was extended to all consumers in a process rolled out over the period 1996–98 (Thomas, 2003).

[1] The report is not readily available now but in the same year, Littlechild and Michael Beesley published a fuller account of their proposals in Beesley M. and Littlechild S., 1983, 'Privatization: principles, problems and priorities', Lloyds Bank Review, 149, 1–20. Reprinted in Bishop M. et al., 1994, Privatization and Economic Performance, Oxford University Press, Oxford, 15–31. The same authors expanded on this in Beesley M. and Littlechild S, 1989, 'The regulation of privatized monopolies in the United Kingdom', Rand Journal of Economics, 20, 3, 454–72.

[2] No serious attempt has been made to introduce competition to the water industry and it is not covered further in this article.

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