



# The British utility regulation model: Its recent history and future prospects<sup>☆</sup>

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## ABSTRACT

This paper considers the evolution of the British model of independent utility regulation from the publication of the 1983 Littlechild Report on telecom regulation. Over the last ten years, the model has faced some threats to its pro-competition emphasis, notably in energy regulation and particularly in electricity. These threats have arisen since 2008 and the onset of the Great Recession. However, with the partial exception of energy, challenges to the independence of regulators and to the role of competition have not been acute. The model seems to have generally been able successfully to meet the challenges faced and, relative to other countries, remains intact, if less distinctive. The main continuing issue is how best to handle repeat price-setting regulatory reviews where new initiatives have been tried but have not as yet reached a settled framework within which to handle the underlying strategic gaming problems.

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## 1. Introduction and context<sup>1</sup>

The Littlechild Report on telecom regulation was published in 1983. It set out the key aspects of the regulatory framework within which Oftel, the new telecom regulator, would operate. The establishment of Oftel in 1984 was an integral element in the privatisation of British Telecom. Since then, independent economic regulators have also been established in Britain for electricity and natural gas, for airports and for railways. For water and sewerage there are separate regulators (a) in England and Wales and (b) in Scotland. Ofwat, the England and Wales water regulator, was established following the 1986 Littlechild Report. In Northern Ireland there is a combined regulator for electricity, gas and water. Postal services in the UK had their own regulator from 2000 to 2011, after which its responsibilities were passed to Ofcom, the telecom and broadcasting regulator.

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The 1983 Littlechild Report “... was and remains a crucial landmark document. After its publication, the world of utility regulation economics and policy-making would never be the same again”. I wrote those words in 2003 for a conference to celebrate the 20th anniversary of the publication of the Littlechild Report.<sup>2</sup> Ten years on, does the British regulatory model still seem to be a success? That was the theme of a conference held at the London School of Economics in March 2014 to mark the 30th anniversary of its publication.

There are various related questions that arise. Have the recommendations of the 1983 Littlechild Report remained central to the operation of British utility regulation? Is the British utility regulation model still significantly different from the approaches used in other countries – and from the US model? How well has the model addressed the challenges of the Great Recession since 2008? What has changed in this area since 2003, what has remained the same and what can we expect over the next 10 years and beyond?

This paper explores the questions above. As other papers in this Special Issue will explore EU and Australian experience plus

<sup>2</sup> See Stern (2003). This paper was one of a set published by CRI at the University of Bath School of Management. The 2003 Conference Volume can be found at [http://www.bath.ac.uk/management/cri/pubpdf/Conference\\_seminar/31\\_Model\\_Utility\\_Regulation.pdf](http://www.bath.ac.uk/management/cri/pubpdf/Conference_seminar/31_Model_Utility_Regulation.pdf).

experience with utility regulation in developing countries, this paper focuses almost entirely on British utility regulation experience.<sup>3</sup> Section 2 of the paper outlines the key characteristics of the British utility regulation model as it currently exists. Section 3 sets out the position of British utility regulation and the Littlechild Report as it looked in 2003 at the 20th anniversary of its publication. Section 4 outlines the main pressures that have arisen over the last ten years and Section 5 outlines the main changes that have resulted in the British regulatory framework over this period. The paper concludes by asking whether and how far a distinctive British regulatory model still exists – and whether or not it is likely to continue to do so.

## 2. Key characteristics of the post-privatisation British model of utility regulation

It is worth setting out explicitly the key characteristics of the post-privatisation British model of regulation before considering continuities and changes since 2003. I list below what I think are the key characteristics as they have developed since the Littlechild Report of 1983.

They are as follows:

### 2.1. Independence

Independent regulation is the corner-stone of British regulation. There are two key aspects of independence, firstly, independence from government; and, secondly, independence from regulated companies. Much more focus goes onto the first aspect – the boundary between policy and regulation, but the second is also important.

As regulatory systems remain in place for longer periods, there is inevitably continued regular contact between regulatory agencies and their staff with regulated companies. Particularly for regulated industries with a single monopoly company (e.g. National Grid and electricity transmission) or a dominant player (e.g. BT), there is the risk that regulators and regulated companies increasingly share a common viewpoint. In the UK, there have been no obvious major crises in this area, although the implications for the conduct of repeat regulation have been recognised – as will be discussed Sections 4 and 5.

The issue of independence from government has been a somewhat more contentious issue in Britain over the last five years or so, particularly in energy. This is discussed in Section 5 below.

### 2.2. Forward-looking incentive regulation

The central feature of price regulation in the British utility model is the periodic resetting of regulated prices in the light of forward looking efficiency gains and investment requirements. The price cap period has strongly tended to 5 years, but this is not a formal obligation and Ofgem have recently moved to an 8 year period between major reviews for network price resetting.

Regulators also have a financeability obligation which implies the right of regulated companies to have the expectation of earning a reasonable rate of return on their assets. This cost of capital concern has become progressively important since the 1980s. A lot of time and effort is spent on designing strong incentives to improve the efficiency of regulated companies, but within a

framework where cost of capital (and RAB maintenance issues) have become increasingly important.

### 2.3. Focus on consumers and their welfare

A focus on consumers and the prices, quality of service and security of supply has been central to the British regulatory model since the 1980s and remains so today. The clearest statement of this is in the Utilities Act 2000 which explicitly defined consumers to include both existing and future consumers.<sup>4</sup>

This statement is important as it establishes the obligation to ensure sufficient maintenance and investment for future consumers. A focus, as in some other countries, just on *current* consumers can be used by governments and regulators to benefit current consumers at the cost – often serious – of future consumers e.g. by driving prices down towards short run marginal costs. This has happened in other countries – especially, but not only, in developing countries. This has not been a major issue in Britain but important inter-generational issues have arisen in the regulated energy and water industries e.g. in the context of how best to manage climate change and its costs over the next 20–50 years and beyond.

### 2.4. An emphasis on competition

Ever since the 1983 Littlechild Report, competition has been seen as the best means of maximising the welfare of consumers of utility industry services, with regulation as a clearly inferior substitute. The role of regulation has been to address problems of major and unavoidable monopoly power e.g. the access to and pricing of monopoly network services. Even there, the focus of regulation has been to regulate networks so as to facilitate competition. Hence, the Communications Act 2003 defines the principal duty of Ofcom with respect to consumers as “[furthering] the interests of consumers in relevant markets, where relevant by promoting competition”.<sup>5</sup>

The pro-competition focus has been shared by all British governments since the 1980s. The Communications Act of 2003 cited above was a product of the 1997–2010 Labour government (as was the Utilities Act 2000) and essentially follows 1980s Conservative government legislation for electricity, gas, water and the 1993 Railways Act.

There is, however, one recent exception to the legal primacy of competition. The Energy Act 2010 requires Ofgem to consider in the regulation of both electricity and gas “whether there is any other manner (whether or not it would promote competition ...) in which the Secretary of State or the Authority [Ofgem and GEMA] ... could carry out those functions which would better protect those interests [the interests of current and future consumers.]”<sup>6</sup> These clauses refer *not just* to the regulation of natural monopoly transmission and distribution assets, *but also* to the supply of gas and electricity. These clauses are very different from those in other legislation which require the regulator “to promote competition where relevant/appropriate”.

In most cases, the relevant competition concept that has been used in British utility regulation has been competition *in* the market – both wholesale and retail markets. However, in some areas, the focus has been on competition *for* the market (e.g. train operating franchises rather than on-rail competition).

<sup>3</sup> I use the term Britain/British and GB rather than United Kingdom and UK as the paper does not discuss the Northern Ireland energy and water industries and their regulation.

<sup>4</sup> See Utilities Act 2000 Clause 6(3) and elsewhere.

<sup>5</sup> Communications Act 2003, Clause 3(1)(b).

<sup>6</sup> Energy Act 2010, Clauses 16 (for natural gas) and 17 (for electricity).

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