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UK experience of utility regulation since 2003 and outlook☆

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ABSTRACT

Regulatory practice continues to be criticised and challenged. Issues which were concerning Government, regulators, companies and consumers in 2003 are, in many respects, still unresolved. There is a risk that too many decisions on developments in regulatory policy will be taken by Ministers rather than regulators, working with companies and consumers in the sectors they regulate, and that Ministers will be unduly influenced by "DIY economics". The main challenge for the next ten years is, therefore, likely to be the relationship between regulators and government.

1. Introduction

Ten years ago, at the conference marking the 20th anniversary of Stephen Littlechild's report on BT regulation, I reviewed the current state of economic regulation and was rash enough to make some predictions about the way it might develop (Bolt, 2003). In this paper, I review experience over the last 10 years, and identify some current challenges to the UK model of independent regulation.

Before doing this, it is worth repeating two observations from my earlier paper. The first, from Professor David Newbery, is as valid now as it was when written 15 years ago: "Practice, which is evolving rapidly, continues to outstrip theory".[2] There is still no textbook which regulators can pick up and adopt wholesale. Regulation remains a learning experience.

But in developing regulation and applying that learning, we need also to be aware of the siren voices of "practical men".[3] Too often, we see Ministers applying what David Henderson called "DIY economics",[4] rather than current best practice.

This matters because regulation has not developed in the simple way Littlechild envisaged for potentially competitive services like BT. In the network industries, where price regulation is likely to be permanent, so-called RPI-X has never existed in a pure form. It is simply a convenient summary label for the approach regulators take at periodic reviews to appropriate restrictions on the revenue that a company can recover and the incentive structures applying to it. That approach differs between sectors, and is continuing to evolve.

2. So where were we in 2003?

Ten years ago, as now, the regulatory model was under challenge. There have been a number of reviews, by Governments, Parliament and independent bodies, as well as by the regulators themselves. It seems fair to say that many of the issues on the table ten years ago are still unresolved.

One of the first actions in this area from the 1997 Labour government was to launch a "utilities review". This reflected concerns about the legitimacy of the UK model in terms of such things as the division of the benefits of privatisation between domestic and industrial customers, the extent to which company management was being excessively remunerated ("fat cats"), and questions about the conduct of regulation, in terms of transparency, the patchy development of competition, and inconsistent approaches to detailed aspects of regulation such as the cost of capital. In the area of capital expenditure, there were concerns about the adequacy of investment incentives.

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[2] Newbery (2000).

[3] "Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist", Keynes (1936).

[4] Henderson (1986).

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None of these issues were really resolved by the outcome of the review. The resulting legislation, although titled "Utilities Act", was primarily about energy regulation, and included the merger of Offer and Ofgas into Ofgem, with new statutory duties. Any idea that all regulators would operate under the same statutory duties was quietly dropped. Nor has the suggestion that the 1998 Competition Act would lead increasingly to regulators relying on general competition powers rather than sector-specific licence powers been borne out in practice.

Reviews have continued, including in particular two by House of Lords committees. Those reports reiterated the importance of independence, both to protect consumers and to underpin effective financing, and also sought to address the balance between ministers and regulators by distinguishing between 'policy' and 'delivery'. However, I suggested in 2003 that a clear-cut distinction was impossible, and that the real issue was that there were multiple objectives for regulated companies. Disagreements about the conduct of regulation were, I suggested, often disagreements about the objectives that were being pursued.[5]

The implications which I drew from this analysis seems to have been borne out in practice. I argued that there was a need to accept that the key utility networks are inevitably public-private partnerships, involving important issues of public policy as well as narrower issues of efficiency and competition.[6]

More specifically, I suggested that:

- political involvement in determining outputs and objectives was inevitable, but this needed to be transparent, leaving regulators full independence in exercising their functions;
- subject to this, there should be a presumption of competitive delivery: but it was for regulators (and the competition authorities) to decide the role, scope and pace of introduction of market mechanisms and supply competition, not Government;
- to underpin this commitment to competition, there was a need for better alignment between the regulatory and competition/merger frameworks; and
- on a technical point, regulators needed to give more explicit consideration to risk allocation between customers and companies, and to consider the implications of this both for the cost of capital and opex and capex allowances.

These have indeed continued to be important issues for regulation. There has been good progress in some areas; in others we seem almost to be going backwards. And even where progress has been made, as with competition in energy, there is controversy about both its effectiveness – as evidenced by the current investigation by the new Competition and Markets Authority – and whether regulatory policy has benefited consumers.

My review of the last ten years therefore covers six aspects of regulation to consider what progress has been made, and what further developments may be expected. The six areas are: development of the RAB model, development of price review procedures, the focus on competition, extensions of the regulatory model, financing, and finally the role and structure of regulators. I discuss each in turn.

3. Development of the RAB (regulatory asset base) model

The RAB (or Regulatory Capital Value) was first developed by Ofwat in 1992. It recognises that the appropriate return to companies should reflect the financial investment made by investors at privatisation rather than the balance sheet value of assets; it is therefore essentially a financial concept. Commitment by regulators to the basis for calculating and rolling forward the RAB is therefore a key element of providing assurance to investors – which after all is one of the central justifications for independent regulation. In the sectors where regulation of network access prices is seen as permanent – energy, water, rail – all regulators have adopted the RAB model. Price reviews are then principally a matter of assessing efficient operating costs, efficient investment programmes, and determining an appropriate return to be applied to the RAB.

Perhaps the most notable development of the RAB model of the past ten years has been the implementation by Ofgem of its new RIIO model, the result of its "RPI-X at 20" review.[7] In some ways, RIIO merely codified current best practice by regulators, recognising that no regulator applied RPI-X in a pure form. However, by extending the review period from five years to eight – albeit with the possibility of a mid-term review – it did change one key feature of the current model.

Ofgem has also put more emphasis on uncertainty mechanisms. These changes have moved the price control framework for energy networks away from that for other networks (principally rail and water), where five year reviews with limited reopeners remain the basis of price controls. Ofwat's separation of retail and wholesale price controls for water companies does, however, open the possibility for water network price controls to evolve towards the Ofgem model in future.

One obvious question about the eight year controls now set for energy networks is whether, in the event, they will indeed survive that long. Five year controls have been seen previously as the best balance between certainty for investment programmes – an important underpinning for efficiency – and uncertainty in the policy and cost environment. Since policy uncertainties are, if anything, increasing, it is clearly possible that a longer price control period with more extensive uncertainty mechanisms now provides a better balance, at least in the energy sector. Only when the effectiveness of those mechanisms has been demonstrated, and the required scope of any mid-term review shown to be limited, will it be possible to reach a conclusion on this.

There is, perhaps, a parallel here with the ill-fated public-private partnership for London Underground. This was set up with 7½ year Periodic Reviews,[8] but with so-called Extraordinary Reviews at any point if changes in costs, for the notional efficient Infraco exceeded a relatively modest Materiality Threshold. Although this model looked workable on paper, in practice it was a failure. In the case of the two Infracos controlled by the Metronet consortium, cost increases far in excess of the Materiality Threshold were allowed to accrue before an Extraordinary Review was called. Given that many of these cost increases were deemed by me, as the independent statutory arbiter, as not "economic and efficient and in accordance with Good Industry Practice" (the test in the contract), Metronet went into administration. The other Infraco, Tube Lines, survived

[5] "There will always be good reasons for retaining regulation … Because we are explicit about having multiple objectives, it is very unlikely that one policy instrument – a price cap for instance – will be sufficient … Regulation must remain ever-alert and ever-changing", Corry (2003).

[6] The 2004 Rail Review, in which I was involved as an adviser before taking up my role as the first chairman of the Office of Rail Regulation in July 2004, described railways as "a public and private sector partnership … specified by Government and delivered by the private sector", DfT (2004).

[7] "RIIO (Revenue = Incentives + Innovation + Outputs) [is] a new performance based model for setting the network companies "price controls which will last eight years" (*Ofgem website*).

[8] Those designing the PPP sought review periods longer than the standard 5 years, but shorter than 10. As the contracts were of 30 year duration, 7½ years was the obvious choice.